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Research

# From Capital to Impact: Role of Blended Finance

## Legal and Regulatory Framework

June 2024

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# Introduction

The pursuit of sustainable development stands as one of humanity's greatest challenges in the 21st century. As the world grapples with complex issues ranging from poverty and inequality to climate change and environmental degradation, the urgency to act has never been greater. The United Nations' Sustainable Development Goals (**"SDGs"**) offer a roadmap for collective action, outlining 17 interlinked objectives aimed at transforming our world by 2030.

However, the path to achieving these ambitious goals is fraught with challenges, chief among them being the staggering shortfall in funding. Current levels of development financing fall far short of what is required, with an estimated annual gap ranging between $ 2.5 trillion and $4 trillion annually *(Figure 1)*[1], needed to realize the SDGs in developing countries alone. This glaring disparity highlights the critical need for innovative financing mechanisms that can mobilize capital at scale.

Blended finance emerges as a beacon of hope in this landscape of financial shortfall. This strategic approach harnesses the power of collaboration between public or philanthropic entities and the private sector to unlock new sources of investment for sustainable development initiatives. The concept is simple yet powerful: by blending concessional capital with market-based investments, blended finance structures create attractive opportunities that appeal to a wide array of investors.

But why is blended finance needed? The answer lies in its ability to address the inherent challenges that hinder private sector investment in sustainable development. Developing countries, despite their immense potential, often face barriers such as high perceived risk and inadequate financial returns compared to other investment opportunities. Blended finance serves as a remedy to these challenges by leveraging public or philanthropic capital to de-risk investments and enhance their attractiveness to private investors.

The numbers speak volumes about the impact of blended finance on sustainable development. To date, approximately $213 billion has been mobilized through blended finance transactions in developing countries, demonstrating its potential to drive tangible change.[2] These transactions range in size from a minimum of $110,000 to a maximum of $8 billion, with the median transaction size standing at $64 million *(Figure 2)*.[3]

1 Financing for Sustainable Development Report 2024, available at: https://desapublications.un.org/publications/financing-sustainable-development-report-2024.

2 Convergence Blended Finance Primer, available at: https://www.convergence.finance/blended-finance.

3 Convergence Blended Finance Primer, available at: https://www.convergence.finance/blended-finance.

Moreover, the investor landscape reflects a diverse mix of stakeholders actively participating in blended finance initiatives. Over 1,910 unique investors have contributed to blended finance transactions, with nearly two-thirds hailing from the private sector. Notable players include impact-focused investors like Ceniarth LLC and Calvert Impact Capital, alongside financial institutions such as Standard Chartered Bank and Société Générale.[4]

Blended finance transactions are not just about financial returns; they are also aligned with the broader objectives of sustainable development. Goal 17 (Partnerships for the Goals), Goal 8 (Decent Work & Economic Growth), Goal 9 (Industry, Innovation, & Infrastructure) and Goal 1 (No Poverty) emerge as the most frequently targeted SDGs in blended finance initiatives, highlighting their multifaceted impact on societal progress.

In this paper, we delve deeper into the concept of blended finance, exploring its key characteristics, archetypal structures and its pivotal role in bridging the funding gap for sustainable development. By examining real-world examples and blending trends across regions and sectors, we aim to shed light on the transformative potential of blended finance as a catalyst for achieving the SDGs.

## Range of Estimate of Annual SDG Financing Gaps in Developing Countries

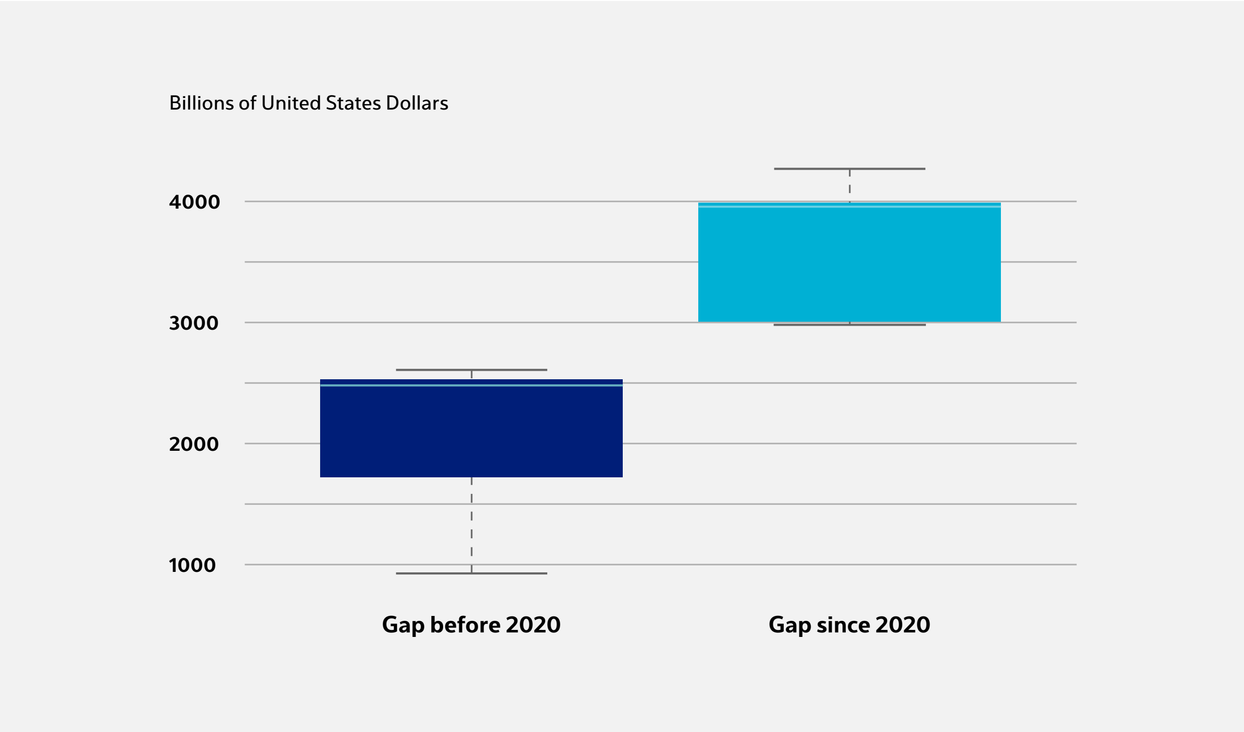


*Figure 1 – Range of estimates of annual SDG financing gaps in developing countries.*[5]

4 Investor landscape reflects a diverse mix of stakeholders actively participating in blended finance initiatives. Over 1,910 unique investors have contributed to blended finance transactions, with nearly two-thirds hailing from the private sector. Notable players include impact-focused investors like Ceniarth LLC and Calvert Impact Capital, alongside financial institutions such as Standard Chartered Bank and Société Générale.

5 Convergence Blended Finance Primer, available at: https://www.convergence.finance/blended-finance.

## Deal Sizes

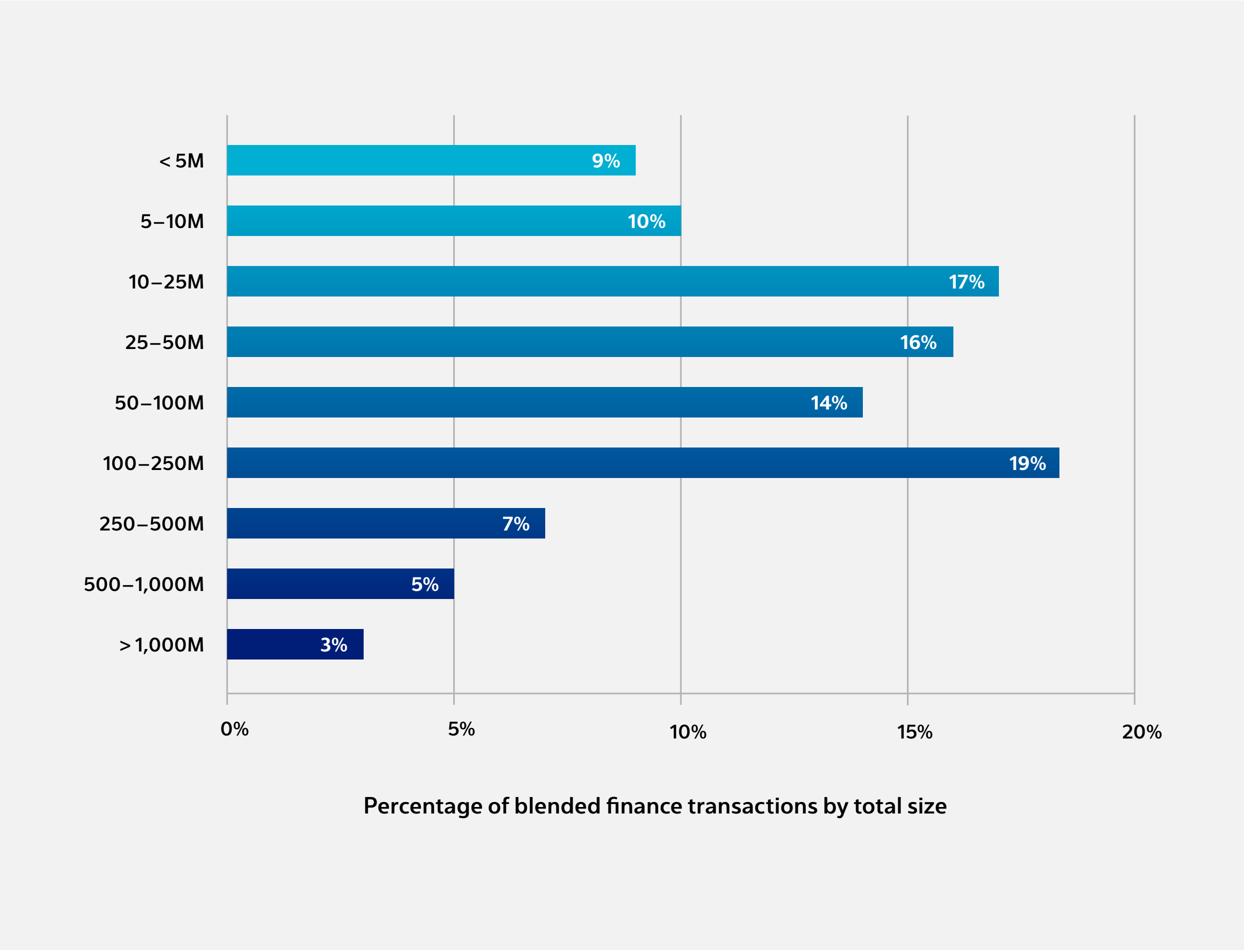


*Figure 2 – Deal size of blended finance transactions / Source: Convergence©Convergence.*

# Definition of Blended Finance

Blended finance emerges as a strategic financial mechanism aimed at catalyzing investments in sustainable development by leveraging the complementary strengths of public, private and philanthropic sectors. While interpretations may vary slightly across institutions, the underlying essence remains consistent: to mobilize additional resources towards achieving the United Nations SDGs in developing countries.

The definition adopted by the United Nations at the Addis Ababa Action Agenda (AAAA) of the Third International Conference on Financing for Development, refers to blended finance as *"the combination of concessional public finance with non-concessional private finance and expertise from both the public and private sectors."*[1] This definition highlights the collaborative nature of blended finance, wherein diverse stakeholders pool their resources and expertise to address complex development challenges.

Similarly, the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) characterizes blended finance as "the strategic use of development finance for mobilizing additional resources towards the SDGs."[2] This broader definition emphasizes the overarching goal of leveraging financial instruments to drive sustainable development outcomes.

Furthermore, the Development Financial Institutions (DFIs) Working Group defines blended finance as *"the combination of concessional finance from donors or third parties alongside DFIs' normal own-account finance and/or commercial finance from other investors, to develop private-sector markets, address the SDGs and mobilise private resources."*[3] This definition highlights the role of DFIs as key facilitators in mobilizing private sector resources for sustainable development projects.

Despite variations in terminology and scope, these definitions converge on the fundamental principles of blended finance:

i. **Public-Private Collaboration:** Blended finance emphasizes collaboration between public, private and philanthropic entities to pool resources, expertise and risk-sharing mechanisms. By harnessing the collective strengths of diverse stakeholders, blended finance endeavors to address development challenges more effectively.

ii. **Resource Mobilization:** At its core, blended finance seeks to mobilize additional financial resources, particularly from the private sector, to complement traditional development finance sources. By blending concessional and commercial finance, blended finance mechanisms aim to attract new investors and unlock capital for impactful projects.

iii. **Alignment with SDGs:** Blended finance is inherently aligned with the SDGs, serving as a conduit for channelling investments towards sustainable development priorities. Whether through poverty alleviation, infrastructure development, or climate action, blended finance mechanisms prioritize projects that contribute to the achievement of the SDGs.

1 For more details refer to: https://unctad.org/system/files/official-document/tdb_efd1_bp_JP_en.pdf.

2 For more details refer to: https://one.oecd.org/document/DCD/DAC(2020)42/FINAL/En/pdf.

3 For more details refer to: https://www.ebrd.com/documents/comms-and-bis/blended-finance.pdf.

In essence, blended finance represents a paradigm shift in development finance, emphasizing innovation, collaboration and impact-driven investments. By harnessing the synergies between public and private actors, blended finance holds the potential to unlock new avenues for sustainable development and foster inclusive growth on a global scale.

### Blended Finance: Improving the Commercial Viability of SDG-Related Investments

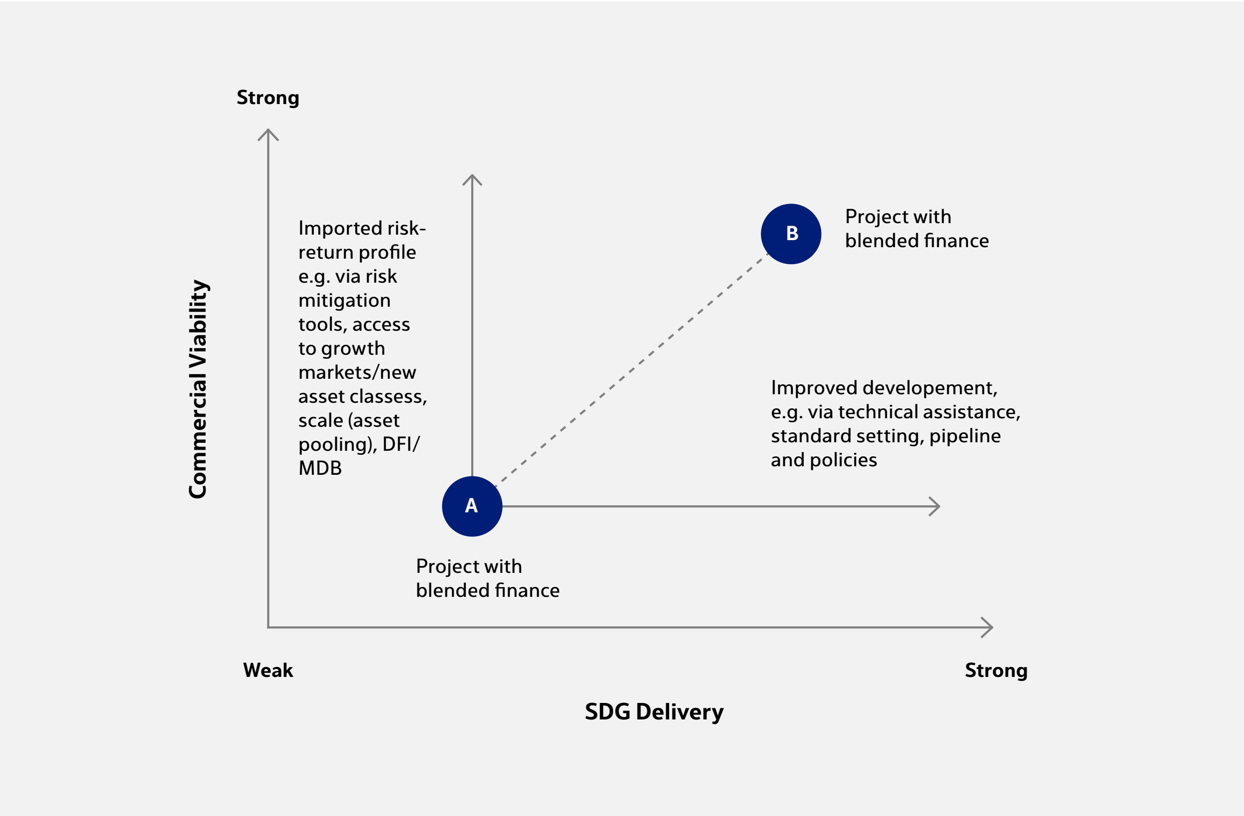


*Figure 3.* [4]

4 Blended Finance : An Overview, available at: https://www.idfc.org/wp-content/uploads/2019/10/blended-finance-a-brief-overview-october-2019_final.pdf.

# Need for Blended Finance[1]

The necessity for blended finance arises from its unique ability to bridge financing gaps and catalyze additional resources for development. Traditional development funders are increasingly drawn to its potential to magnify the impact of their investments and accelerate progress towards the SDGs. By mobilizing private capital alongside public and philanthropic funds, blended finance amplifies the scale and effectiveness of development initiatives.

A notable aspect of blended finance is its versatility across sectors and geographies. From climate resilience and clean energy to healthcare and infrastructure, this approach fosters collaboration among diverse stakeholders to address complex challenges. Moreover, blended finance fosters innovation and knowledge-sharing, driving the adoption of best practices and enhancing skills in investment management and sector-specific expertise.

Most importantly, blended finance plays a crucial role in overcoming market failures and stimulating investment in under-penetrated sectors and markets. By extending the time horizons for capital providers and mitigating risks associated with short-term capital flows, it creates a conducive environment for sustainable development. This approach not only improves terms for borrowers but also cultivates functioning markets where none previously existed, fostering economic growth and resilience.

1 Blended Finance for development – Background paper, available at: https://unctad.org/system/files/official-document/tdb_efd1_bp_JP_en.pdf.

# Source of Catalytic Capital

Blended finance has emerged as a powerful tool in addressing the financing gap for sustainable development projects worldwide. This innovative approach combines public and private sector resources to mobilize capital towards achieving social and environmental objectives. Therefore, understanding the sources of both private and public capital in blended finance becomes imperative for effectively leveraging these resources. In this paper, we delve into the intricacies of the sources of capital in blended finance, exploring the roles of various stakeholders and the legal frameworks governing their participation.

## A. Public Capital Sources

Public capital plays a crucial role in blended finance, often acting as a catalyst for attracting private investment into development projects. The sources of public capital vary and include:

i. **Multilateral Development Banks (MDBs):** MDBs such as the World Bank, Asian Development Bank and African Development Bank are key providers of public capital in blended finance. These institutions mobilize funds from member countries and international markets to finance development projects, often leveraging their resources to attract additional private investment.

ii. **Development Finance Institutions (DFIs):** DFIs, both national and international, are instrumental in providing public capital for blended finance initiatives. These institutions invest in projects with the aim of promoting economic growth, job creation and poverty reduction in emerging markets and developing countries.

iii. **Official Development Assistance (ODA):** ODA, provided by governments and multilateral agencies, constitutes a significant portion of public capital in blended finance. These funds are typically allocated to support projects in developing countries, focusing on areas such as infrastructure development, healthcare, education and poverty alleviation.

iv. **Government Grants and Contributions:** Governments also contribute to blended finance initiatives through direct grants and contributions. These funds may be allocated to specific projects or sectors aligned with national development priorities, enhancing the impact and scalability of blended finance interventions.

Public entities strategically invest in blended finance projects to tackle pressing societal issues and drive sustainable development. They prioritize infrastructure development to enhance connectivity and economic opportunities, leveraging blended finance to attract private sector expertise and accelerate project delivery. Additionally, public entities focus on social impact initiatives, aiming to address poverty, education, healthcare, and gender equality challenges by scaling up programs that improve access to essential services. Moreover, they prioritize climate action and environmental sustainability, supporting projects that reduce emissions, enhance resilience, and protect ecosystems through blended finance mechanisms.

Lastly, public entities usually invest in entrepreneurship and innovation, fostering ecosystems that spur economic growth and job creation while providing support for startups and SMEs to thrive in emerging industries. Through these strategic investments, public entities harness the power of blended finance to maximize impact and drive positive change in communities worldwide.

## B. Private Capital Sources

Private capital complements public resources in blended finance, bringing additional investment expertise, innovation and efficiency to development projects. The sources of private capital include:

i. **Institutional Investors**: Institutional investors such as pension funds, insurance companies and sovereign wealth funds are increasingly participating in blended finance initiatives. These investors seek to generate financial returns while also achieving social and environmental impact, aligning with their sustainability objectives.

ii. **Impact Investors:** Impact investors allocate capital to projects that generate positive social and environmental outcomes alongside financial returns. These investors play a critical role in blended finance, providing patient capital and expertise to support sustainable development initiatives.

iii. **Commercial Banks:** Commercial banks play a dual role in blended finance, both as providers of capital and as intermediaries facilitating transactions. Banks provide debt financing to development projects, leveraging their networks and expertise to structure deals that meet the needs of both investors and project developers.

iv. **Private Equity and Venture Capital:** Private equity and venture capital firms invest in businesses and projects with high growth potential, including those in emerging markets and sectors such as renewable energy, healthcare and technology. These investors contribute expertise, networks and risk capital to blended finance initiatives, supporting innovation and entrepreneurship.

v. **Corporate Social Responsibility (CSR) Funds:** Corporations allocate a portion of their profits towards CSR initiatives, including investments in blended finance projects. CSR funds support initiatives that generate positive social and environmental outcomes, aligning with companies' sustainability objectives and enhancing their corporate reputation.

In the realm of blended finance initiatives, various entities contribute private capital to drive SDGs forward. Institutional investors, including pension funds and sovereign wealth funds, seek to diversify portfolios while aligning with ESG considerations. Impact investors prioritize measurable social and environmental outcomes alongside financial returns. Venture capital and private equity firms foster innovation and entrepreneurship by financing startups and SMEs in emerging markets. Philanthropic foundations and family offices deploy capital towards social causes, while corporations allocate funds from CSR initiatives towards projects that align with sustainability goals. Together, these diverse entities leverage their resources and expertise to catalyze positive change and address pressing global challenges through blended finance.

# Blended Finance Instruments and Mechanisms

Blended finance instruments and mechanisms have emerged as critical drivers in bridging the financing gap for sustainable development initiatives worldwide. By combining resources from both public and private sectors, these innovative approaches offer promising solutions to mobilize capital and accelerate progress towards achieving global development goals. In this section, we delve into the diverse range of blended finance instruments and mechanisms, exploring their roles in mitigating risks, attracting investment and fostering collaboration across stakeholders.

## A. Outcome-Based Instruments

Outcome-based instruments, including Social Impact Bonds **("SIBs")**, Development Impact Bonds **("DIBs")**, and Social Success Notes **("SSNs")**, represent a novel approach in finance aimed at tethering the allocation of funds or returns on investment to the attainment of specific social outcomes. Departing from conventional financing modalities, these instruments prioritize the achievement of measurable and verifiable results over mere inputs or activities. DIBs, particularly prominent among such mechanisms, entail results-based contracts wherein private investors furnish working capital for social initiatives, typically overseen by service providers like NGOs. Notably, outcome funders, often comprising donor agencies or philanthropic entities, commit to reimbursing investors their principal along with a return, contingent upon the successful realization of predetermined outcomes as evaluated by impartial third parties. Despite their increasing global adoption, particularly in sectors like education and health, the utilization of these instruments in low-income or lower middle-income nations remains somewhat restricted. Advocates underscore their potential to mobilize private capital, foster collaboration, spur innovation, enhance accountability, and ultimately enhance performance toward desired outcomes, thus aligning development financing with tangible results and optimizing the effectiveness of development expenditures.

However, inherent risks accompany the utilization of outcome-based instruments. Chief among these risks is the possibility of outcome performance failure, wherein if the project fails to meet predefined targets, the service provider may not receive full payment. Additionally, challenges related to data collection and evaluation may arise, potentially impeding the accurate assessment of outcomes. Moreover, the administrative burden associated with reporting requirements can divert resources and time away from project delivery, thereby posing a logistical challenge to implementation. Despite these risks, proponents argue that the potential benefits of outcome-based instruments in driving positive social change outweigh the associated challenges, making them a promising avenue for innovative financing in the development sector.

## Impact Bond

Impact bonds, also known as social impact bonds or pay-for-success contracts, are innovative financing instruments that bring together diverse stakeholders to address social challenges effectively. These bonds involve private investors, service providers, outcome funders, independent evaluators and program managers, all working collaboratively towards achieving predefined social outcomes. The process begins with stakeholders entering into a contractual agreement that outlines the specifics of the bond, including performance metrics and payment mechanisms. If the predetermined outcomes are achieved, the outcome funder compensates the investor with an agreed-upon return on investment (ROI). Independent evaluators assess the progress and impact of the project, ensuring accountability and transparency. For donors, impact bonds offer attractive returns, averaging 4-6% globally and 3-4% in India, while for service providers, access to private capital facilitates the scaling of project interventions, with financial risks shared by investors.[1]

Impact bonds provide a structured framework for addressing complex social issues while promoting collaboration and risk-sharing among stakeholders. By aligning financial incentives with social outcomes, these instruments offer a promising avenue for driving meaningful social change and leveraging private sector resources for the public good.

## Social Impact Guarantee

The concept of a social impact guarantee represents a contractual mechanism aimed at aligning financial interests with social outcomes. At its core, this arrangement involves multiple stakeholders, including a service provider, an outcome funder, a performance guarantor and an independent evaluator. Through a formal agreement, these parties establish clear and measurable outcome metrics, with the performance guarantor assuming the responsibility of reimbursing the outcome funder if the predetermined outcomes are not achieved. This structure effectively mitigates the financial risk for the funder while incentivizing the service provider to deliver on the pre-agreed goals.[2]

Central to the social impact guarantee model is the establishment of performance metrics that serve as benchmarks for success. These metrics are rigorously evaluated by an independent evaluator, ensuring accountability and transparency throughout the process. If the predefined outcomes are met, the outcome funder disburses the agreed-upon return on investment to the investor. However, in cases where the outcomes fall short, the performance guarantor steps in to cover the financial obligations, thus safeguarding the funder's capital.

From the perspective of donors, this model offers enhanced efficiency in achieving social outcomes by aligning financial incentives with impact metrics. On the other hand, for service providers, access to private capital through this mechanism facilitates the scaling of project interventions while sharing the financial risk with the performance guarantor. Moreover, there exists the potential for additional payment if the outcomes are exceeded, further incentivizing effective performance and innovation within the social sector.

1 Bridging Perspective: Innovative Finance Insights from India, available at: https://www.isdm.org.in/themes/custom/isdm/assets/pdf/bridging-perspectives-innovative-finance-insights-from-india.pdf.

2 Understanding Social Impact Bonds, available at: https://www.oecd.org/cfe/leed/UnderstandingSIBsLux-WorkingPaper.pdf.

### Social Success Rate

The SSR within the Social Success Note (SSN) model serves as a pivotal indicator of the effectiveness of collaborative efforts in achieving predetermined social outcomes. It represents the culmination of a concerted partnership among key stakeholders aimed at driving meaningful societal impact.

The SSR is underpinned by the involvement of various actors, each playing a distinct role in the process. The risk investor provides concessional loans to social enterprises, while the outcome funder commits to offering a premium if agreed-upon outcomes are met. An independent evaluator ensures impartial assessment of progress, while the program manager coordinates activities among stakeholders, ensuring alignment with project objectives.

The process begins with stakeholders entering into a contractual agreement, defining terms and performance metrics. Clear and measurable outcome metrics are established, against which progress is evaluated by the independent evaluator. Investors receive financial returns based on interest payments or profits generated by social programs.

Ultimately, the SSR encapsulates the value proposition of the SSN model for all stakeholders involved. Investors benefit from financial and social returns, while social enterprises gain access to affordable debt and validation of their impact-driven approach. This collective effort underscores the significance of collaboration, accountability and transparency in driving sustainable social change.

## B. Risk-Based Instruments

Risk-based instruments play a crucial role in mitigating financial risks associated with investing in social sector projects, thereby fostering an environment conducive to capital flow into socially impactful initiatives. These instruments, such as partial credit guarantees, pari-passu guarantees and first loss default guarantees, provide a layer of financial security for investors and lenders. By offering assurance against potential losses, risk-based instruments make social projects more attractive to investors, encouraging their participation in funding endeavors that contribute to societal welfare.[3]

Key players in the implementation of risk-based instruments include investors, guarantors, and social enterprises. Investors, ranging from impact investors to private equity and venture capital firms, provide the necessary financing for social enterprises. Guarantors, which may include government-led agencies, philanthropic organizations and development finance institutions, offer the guarantees that mitigate risks for investors and lenders. These guarantees serve as a safety net, assuring investors of financial protection in case of project underperformance or default.

Social enterprises, as the primary beneficiaries of these guarantees, gain access to much-needed capital for their projects. By attracting investors through risk-based instruments, social enterprises can pursue their missions with greater confidence, knowing that financial risks are managed effectively. This symbiotic relationship between investors, guarantors, and social enterprises creates a framework where financial interests align with social impact goals, facilitating the advancement of initiatives aimed at addressing pressing societal challenges.

3 Guide to blended finance, available at: https://www3.weforum.org/docs/WEF_How_To_Guide_Blended_Finance_report_2015.pdf.

### Partial-Credit Guarantee (PCG)

A PCG serves as a financial arrangement in which a guarantor assumes responsibility for covering a specific portion of losses incurred by an investor or lender in the event of borrower default. This arrangement mitigates the lender's risk and encourages investment in projects or organizations that may otherwise be deemed too risky or lack sufficient collateral. By providing such a guarantee, a third-party guarantor enhances the creditworthiness of the borrower, thus making it more feasible for them to secure financing for their endeavors.

The value proposition of a PCG lies in its ability to bolster the creditworthiness of social enterprises with solid business models and a proven track record. This enhancement in creditworthiness makes these enterprises more attractive to lenders, facilitating access to financing that is crucial for their growth and sustainability. Essentially, the guarantee serves as a stamp of confidence in the borrower's ability to meet their financial obligations, thereby reducing the perceived risk associated with extending credit.[4]

However, it's important to acknowledge the potential risks associated with PCG. While they can indeed enhance creditworthiness, there is a possibility that the presence of such a guarantee may lead to questions regarding the borrower's true creditworthiness. Lenders may perceive the guarantee as a form of compensation for underlying weaknesses in the borrower's financial standing, which could potentially result in higher borrowing costs or more stringent terms. Therefore, while a PCG can be a valuable tool for accessing financing, borrowers must be mindful of its potential implications and ensure transparency in their financial dealings.

### First-Loss Default Guarantee (FLDG)

A FLDG is a financial arrangement designed to mitigate the risk associated with lending to startups or early-stage social enterprises. In this arrangement, a guarantor assumes responsibility for covering the initial losses incurred by a lender in the event of default by the borrower on the loan. This serves as a form of insurance for the lender, providing them with a degree of protection against potential financial losses stemming from the borrower's inability to meet their repayment obligations.

The primary value proposition of a FLDG lies in its ability to de-risk investments for private investors who may be hesitant to provide funding to social enterprises in their early stages of development. By offering assurance that the initial losses resulting from borrower default will be covered, the FLDG incentivizes investors to participate in financing ventures with limited track records or unproven business models. This, in turn, facilitates greater access to capital for startups and social enterprises, enabling them to pursue their objectives and contribute to positive social impact.[5]

However, it is important to recognize that FLDG come with inherent risks. One such risk is the limited loss absorption capacity of the guarantee. While the guarantor agrees to cover losses up to a specified amount, any losses exceeding this threshold are typically borne by the lender. This means that in scenarios where the magnitude of the default surpasses the predetermined coverage limit, the lender remains exposed to the remaining financial risk. Therefore, lenders must carefully assess and manage their exposure to potential losses when entering into FLDG arrangements, ensuring that they maintain a prudent level of risk mitigation.

4 For more details refer to: https://www.ifc.org/content/dam/ifc/doc/2023/ifc-product-description-partial-credit-gurantees.pdf.

5 First Loss Guarantee, available at: https://socialfinance.org.in/fldg/.

## C. Debt-based Instruments

Debt-based instruments represent a strategic approach to mobilize financial resources for advancing social sector initiatives. By leveraging debt, these instruments aim to attract a diverse array of investors, including individuals, impact funds, development finance institutions and governments, keen on supporting projects that drive social change. The utilization of debt allows recipients, typically organizations seeking finance, to tap into private capital sources that may otherwise be inaccessible to them. These instruments encompass various forms such as subordinated debt, concessional debt and interest subvention, each tailored to meet specific needs and circumstances.

The process of deploying debt-based instruments involves several key stages. It commences with the identification of social projects aligned with the objectives of potential investors, followed by rigorous project evaluation to gauge feasibility and impact. Subordinated debt, characterized by higher interest costs and limited financial flexibility, may be utilized, albeit ranking lower in repayment priority compared to other creditors. Concessional debt offers favourable terms and conditions, including lower interest rates and extended repayment periods, albeit with compliance and reporting requirements. Interest subvention programs subsidize interest costs on loans, reducing the overall borrowing expenses.

Effective negotiation of terms and conditions is essential to structure these instruments and delineate the roles and responsibilities of stakeholders involved. Legal documentation and agreements formalize these arrangements, ensuring clarity and enforceability. Upon agreement, funds are disbursed to support the chosen projects, with ongoing monitoring, evaluation and reporting mechanisms in place to assess project success and ensure compliance with regulatory requirements.

### Concessional Debt

Concessional debt refers to borrowed funds extended with more favorable terms and conditions than those typically offered by standard market loans. These terms often entail lower interest rates, extended repayment periods, or grace periods before repayment obligations commence.[6] The primary aim of concessional debt is to foster positive social outcomes rather than solely prioritizing substantial financial returns. However, it's important to note that while concessional debt offers these advantageous terms, it may also entail certain risks. One such risk involves compliance and reporting obligations, which could impose specific requirements on the borrower, thereby increasing administrative burdens and associated costs. Additionally, recipients of concessional capital may face challenges in securing new sources of funding once the concessional period expires, potentially leading to difficulties in maintaining favorable terms for future financial arrangements. Thus, while concessional debt presents an opportunity to access capital on more favorable terms, careful consideration of its associated risks is essential for informed decision-making and sustainable financial management.

6 Debt concessionality, available at: https://unstats.un.org/unsd/nationalaccount/RAdocs/F15_GN_Debt_Concessionality.pdf.

 

### Interest Subvention

Interest subvention is a financial mechanism employed by governments or development institutions to provide assistance to borrowers in the social sector. This support comes in the form of subsidizing the interest cost on loans, effectively reducing the financial burden associated with borrowing for social projects. By mitigating the interest expenses, interest subvention aims to facilitate easier access to capital for initiatives aimed at addressing societal needs.[7]

However, it's crucial to acknowledge the inherent risks associated with interest subvention programs. Firstly, such initiatives often face constraints in funding availability, limiting their scope and impact. Additionally, there's a potential for distorted incentives wherein borrowers might be tempted to take on excessive debt or make less prudent financial decisions due to the allure of subsidized interest rates. This could result in the misallocation of resources and undermine the efficiency of social financing efforts. Therefore, while interest subvention offers tangible benefits in reducing borrowing costs for social endeavors, careful oversight and management are imperative to mitigate associated risks and ensure optimal utilization of resources.

## D. Hybrid Instruments

Hybrid instruments represent a dynamic approach to financial structuring, blending various elements such as grants, equity and debt to optimize both financial returns and social impact. These instruments offer a flexible framework for investors, recipients, intermediaries and evaluation partners to engage in sustainable finance initiatives.

One such instrument is returnable grants, which combine aspects of grants and repayable funding. This mechanism allows investors, including philanthropic foundations and impact investors, to provide financial support to recipients, such as social enterprises, with the expectation of partial or full repayment based on the project's success. Returnable grants offer a balance between philanthropic giving and financial sustainability, encouraging recipients to achieve measurable social outcomes while ensuring investors' capital is utilized effectively.

A returnable grant is an innovative financial instrument designed to provide short-term, affordable, and flexible capital to individuals and social enterprises. Unlike traditional loans, returnable grants entail zero interest and zero collateral requirements, making them accessible to a broader range of recipients, including not-for-profit and for-profit social enterprises, as well as social entrepreneurs. The distinguishing feature of a returnable grant lies in its repayment mechanism, which is based on a moral obligation rather than a legal one. Recipients are expected to repay the grant funds, not out of legal compulsion, but rather as a commitment to uphold the principles of reciprocity and social responsibility.

7 For more details refer to: https://www.nabard.org/content1.aspx?id=602&catid=23&mid=23.

The structure of a returnable grant allows funds to be directly credited to the accounts of selected participants, facilitating swift access to capital. This approach not only fosters financial inclusivity but also acknowledges the potential of the recipients to repay collectively as a cohort. While the returnable rates associated with these grants can be substantial, reaching as high as 80%, they serve as a testament to the leverage of funds channeled through this mechanism. However, it's essential to recognize that the implementation of returnable grants may entail certain risks, such as the imposition of monitoring and reporting requirements to track progress and impact, which could potentially burden the recipients.

# Section 2

# Legal Framework Applicable to Blended Finance

Blended finance models, integrating public and private funding to address social and environmental challenges, have emerged as potent mechanisms for sustainable development. However, effective implementation hinges on navigating a complex legal landscape. This section delves into the legal intricacies surrounding blended finance initiatives in India, examining operational challenges, regulatory frameworks for private and public capital and contradictions therein.

Blended finance initiatives operate within the purview of diverse legal frameworks, encompassing both domestic and international regulations. Key legislations include the Foreign Contribution Regulation Act,2010 (**"FCRA"**), Foreign Exchange Management Act, 1999 (**"FEMA"**), Corporate Social Responsibility (**"CSR"**) laws, Income Tax Act, 1961 (**"ITA"**) and Securities Exchange Board of India (Alternate Investment Funds) Regulations, 2012 (**"SEBI AIF Regulations"**). These statutes delineate parameters for fundraising, investment, governance and compliance, shaping the contours of blended finance endeavors.

## A. SEBI (Alternate Investment Funds) Regulation, 2012

The SEBI AIF Regulations, hold significant relevance within the domain of blended finance, where diverse funding sources are combined to address social welfare objectives. Blended finance models, inherently complex yet promising, seek to mobilize capital from various stakeholders to drive sustainable development initiatives. Within this context, SEBI AIF Regulations provide a structured framework for establishing Social Impact Funds (**"SIFs"**), designed specifically to prioritize investments in social ventures and enterprises:

i. **Establishment of SIF:** According to Regulation 2(tb) of the SEBI AIF Regulations, a "social impact fund" refers to an AIF primarily investing in securities, units, or partnership interests of social ventures or enterprises, while satisfying laid-down social performance norms.[1] These funds are categorized as Category I AIFs and are instrumental in mobilizing capital for socially beneficial projects.[2] Notably, Regulation 2(u) defines "social venture," encompassing various entities formed with the purpose of promoting social welfare, including public charitable trusts, societies, companies registered under Section 8 of the Companies Act, 2013 (**"Companies Act"**) and microfinance institutions.[3]

1 Regulation 2(tb) of AIF Regulations: "Social impact fund" means an Alternative Investment Fund which invests primarily in securities, units or partnership interest of social ventures or securities of social enterprises and which satisfies the social performance norms laid down by the fund;

2 Regulation 3(4)(a) of the AIF Regulations: "Category I Alternative Investment Fund" which invests in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME Funds, [social impact funds], infrastructure funds, [special situation funds] and such other Alternative Investment Funds as may be specified;

Explanation: For the purpose of this clause, Alternative Investment Funds which are generally perceived to have positive spillover effects on economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions shall be included and such funds which are formed as trusts or companies shall be construed as "venture capital company" or "venture capital fund" as specified under sub-section (23FB) of Section 10 of the Income Tax Act, 1961.

3 Regulation 2(u) of the AIF Regulations: "Social venture" means a trust, society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solving social problems or providing social benefits and includes, (i) public charitable trusts registered with Charity Commissioner; (ii) societies registered for charitable purposes or for promotion of science, literature, or fine arts; (iii) [company registered under section 8 of the Companies Act, 2013;] (iv) micro finance institutions.

ii. **Capital raising and investment structures:** Under Regulation 10(a) of the SEBI AIF Regulations, SIFs are permitted to raise funds from any investor, whether Indian or foreign, by issuing units.[4] Additionally, SIFs have the discretion to issue **"social units"** to investors who solely seek social returns without financial dividends.[5] Each scheme of a SIF is mandated to maintain a minimum corpus of five crore rupees, ensuring sufficient capitalization to pursue social impact objectives effectively.[6]

iii. **Investment Conditions and additional requirements:** SIFs are subject to specific investment conditions outlined in Regulation 16 of the SEBI AIF Regulations. Notably, at least seventy-five percent of the investable funds of a SIF must be directed towards unlisted securities, partnership interests of social ventures, or securities of social enterprises. Moreover, SIFs are permitted to accept grants, provided that the utilization of such grants aligns with the fund's social impact objectives and does not result in financial returns for the grant provider.[7]

iv. **Legal and Regulatory challenges:** Despite the regulatory framework outlined by SEBI, challenges persist concerning the interplay between AIF regulations and other statutes such as the FCRA and the ITA. Discrepancies between these frameworks, particularly regarding the eligibility of non-profit entities to receive foreign grants and tax implications, necessitate greater regulatory clarity and alignment to ensure the seamless operation of blended finance models.

One such instance is the legislative blind-spot between the AIF regulations and FCRA. While on one hand the AIF regulations allow the SIF to receive grants from both domestic as well as foreign sources, the provision of FCRA clearly state that the grants / foreign contribution cannot be received by a non-profit in India, without the prior approval of the Ministry of Home Affairs (**"MHA"**). Furthermore, the while most of the SPV's are for-profit in nature, the FCRA only envisages non-profits entities to receive foreign grants in India. Even under the ITA only non-profit organisations are considered to be eligible entities receiving tax-exempt status under the ITA.

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4 Regulation 10(a) of the AIF Regulations: The Alternative Investment Fund may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units [:] [Provided that a social impact fund or schemes of a social impact fund may also issue social units.

5 Regulation 2(td) of the AIF Regulations: "Social units" means units issued by a social impact fund or schemes of a social impact fund to investors who have agreed to receive only social returns or benefits and no financial returns against their contribution.

6 Regulation 10(b) of the AIF Regulation: Each scheme of the Alternative Investment Fund shall have corpus of at least twenty crore rupees [:] [Provided that each scheme of the social impact fund shall have a corpus of at least five crore rupees.

7 Regulations 16(1) of the AIF Regulations: The following investment conditions shall apply to all Category I Alternative Investment Funds: [(a) Category I Alternative Investment Fund shall invest in investee companies, venture capital undertakings, special purpose vehicles, limited liability partnerships [,] in units of other Category I Alternative Investment Funds of the same sub category [, or in units of Category II Alternative Investment Funds as specified in this regulation, [(aa) Category I Alternative Investment Funds may engage in hedging, including credit default swaps in terms of the conditions as may be specified by the Board from time to time.] (b) [***](c) Category I Alternative Investment Funds shall not borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than ten percent of the [investable funds].

Regulation 16(4) of the AIF Regulations: The following conditions shall apply to social [impact] funds in addition to the conditions laid down in sub-regulation (1): (a) [at least seventy-five percent of the investable funds shall be invested in unlisted securities or partnership interest of social ventures or in units of social ventures or in securities of social enterprises: Provided that an existing social impact fund may invest the remaining investable funds in securities of not for profit organizations registered or listed on a social stock exchange with the prior consent of atleast 75% of the investors by value of their investment;] (b) such funds may accept grants, provided that such utilization of such grants shall be restricted to clause (a) [:] [Provided that the amount of grant that may be accepted by the fund from any person shall not be less than [ten lakh rupees]: [Provided further that the minimum amount of grant shall not apply to accredited investors:] Provided further that no profits or gains shall accrue to the provider of such grants. 3[(ba) Notwithstanding the provisions of clauses (a) and (b), a social impact fund or schemes of a social impact fund launched exclusively for a not for profit organization registered or listed on a social stock exchange, shall be permitted to deploy or invest hundred percent of the investable funds in the securities of not for profit organizations registered or listed on a social stock exchange.] (c) such funds may give grants to social ventures or social enterprises, provided that appropriate disclosure is made in the placement memorandum.

## B. CSR Laws

In the realm of blended finance, the applicability of CSR laws is paramount, serving as a framework within which companies navigate their social and environmental obligations alongside financial objectives. Primarily anchored in Section 135 of the Companies Act and subsequent CSR Rules of 2014 (**"CSR laws"**), these regulations mandate companies meeting specific financial thresholds to allocate a portion of their profits towards CSR activities. Pertinently, entities with an annual turnover exceeding INR 10 billion, a net worth surpassing INR 5 billion or more, or a net profit exceeding INR 0.05 billion or more during any financial year fall within the purview of these mandates.[8]

Under Section 135 of the Companies Act read with Schedule VII of the Act, companies delineate their CSR activities, covering diverse areas such as poverty alleviation, education promotion, gender equality, healthcare improvement, environmental sustainability, vocational skill enhancement and contributions to governmental relief funds. The requirement entails spending at least two percent of the average net profits made during the preceding three financial years on CSR endeavours or providing explanations for non-expenditure. This allocation is substantial, with companies collectively contributing approximately INR 12,000 crores annually, juxtaposed against the government's substantially larger social sector expenditure.

The Companies typically execute the CSR activities through three routes:

a. **Activities route:** This is the direct mode where the Companies directly undertake CSR projevts or programmes as per Schedule VII of the Act, either by itself or by engaging implementing agencies as prescribed under the Companies Act.

b. **Contribution to funds route:** This route allows the Companies to make contribution to various funds, as specified in Schedule VII of the Act.

c. **Contribution to Incubators and R&D projects:** This mode allows the Companies to make contribution to the institutes / organisations, engaged in research and development activities, as specified under item (ix)(b) of the Schedule VII of the Act.

Moreover, companies may execute their CSR activities through implementing agencies which may include registered trusts, societies or companies established by themselves or their affiliates, subject to certain conditions. Notably, entities not established by the company must possess a three-year track record in similar initiatives. Collaboration among companies for CSR projects is permissible, provided each entity's CSR committee can independently report on their contributions. Additionally, for-profit organizations may engage in CSR projects, albeit restricted to five percent of the total allocable CSR funds, primarily for capacity building and training purposes.

8 Section 135(1) of the Companies Act.

Furthermore, the mandate necessitates the formation of a CSR Committee comprising three or more directors, tasked with formulating CSR policies, recommending expenditure and monitoring policy implementation. The Board of Directors, in turn, approves the CSR policy, ensuring its disclosure in company reports and on their websites, if applicable. This structured approach ensures alignment between corporate initiatives and societal welfare objectives, fostering sustainable development within the paradigm of blended finance.

## Legal and Regulatory Concerns

i. **Eligibility criteria for CSR funds recipient:** Stringent interpretation of CSR rules poses challenges for entities receiving CSR funds, such as incubators. Criteria related to tax-exempt status may restrict the ability of certain organizations to access CSR funding. While the CSR laws, specifically item (ix) of Schedule VII permits Companies to make contributions to Incubators,[9] most corporates require the implementing agency to posses CIN registration number and requisite certificates under Section 12A and Section 80G of the ITA, creating barrier for organisation like incubators, who due to their structure are not eligible to get certification under Section 12A of the ITA.[10] This restrictive interpretation limits the pool of potential recipients, hindering the effectiveness of CSR allocations in addressing societal needs.

ii. **Board approval for innovative CSR approaches:** Innovative CSR approaches, such as utilizing CSR funds for outcome funding or supporting blended finance initiatives, may require board approval. However, boards may be hesitant to approve unconventional CSR strategies due to regulatory uncertainties and risk aversion. Corporate boards often prioritize compliance and risk management when evaluating CSR initiatives, leading to reluctance in approving novel approaches that deviate from traditional CSR practices. This risk aversion may stifle innovation and limit the potential impact of CSR funds in driving sustainable development.

iii. **Compliance and reporting requirements:** The integration of CSR funds into blended finance models complicates compliance and reporting processes, as expenditures must be accurately tracked and reported across multiple projects and stakeholders. Inadequate monitoring and reporting mechanisms may undermine transparency and accountability, leading to regulatory non-compliance and reputational risks.

9 Schedule VII, Item No. (ix) of Companies Act: (ix) (a) Contribution to incubators or research and development projects in the field of science, technology, engineering and medicine, funded by Central Government or State Government or Public Sector Undertaking or any agency of the Central Government or State Government; and (b) Contributions to public funded Universities; Indian Institute of Technology (IITs); National Laboratories and autonomous bodies established under Department of Atomic Energy (DAE); Department of Biotechnology (DBT); Department of Science and Technology (DST); Department of Pharmaceuticals; Ministry of Ayurveda, Yoga and Naturopathy, Unani, Siddha and Homoeopathy (AYUSH); Ministry of Electronics and Information Technology and other bodies, namely Defense Research and Development Organisation (DRDO); Indian Council of Agricultural Research (ICAR); Indian Council of Medical Research (ICMR) and Council of Scientific and Industrial Research (CSIR), engaged in conducting research in science, technology, engineering and medicine aimed at promoting Sustainable Development Goals (SDGs).

10 For more details refer to Form CSR-1, available at: https://www.mca.gov.in/MinistryV2/companyformsdownload.html.

## C. Foreign Contribution Regulation Act, 2010

FCRA assumes a critical role in the realm of blended finance, particularly concerning the financing of social impact projects. The FCRA regulates the acceptance and utilization of foreign contributions by entities in India. Its primary objective is to ensure that foreign funds are not utilized for activities detrimental to national interest or for any political purposes. As per FCRA provisions, any transfer of foreign contributions, whether in cash or kind, to entities in India is subject to stringent regulations. Therefore, the foreign funding component in blended finance arrangements falls within the purview of FCRA. Here are the key provisions of FCRA pertinent to such models:

i. **FCRA Registration:** It is pertinent to mention here that only those entities that have sought prior permission or registration with MHA as per Section 11 and 12 of FCRA are permitted to receive foreign contributions in India.

ii. **Acceptance and utilization of foreign contribution:** The non-profit organisation receiving foreign contribution must adhere to Section 7 of the FCRA, which prohibits the transfer of foreign contribution to other entities in India, regardless of their FCRA registration status.[11] The he interpretation of 'transfer' provided in the Noel Harper v. Union of India judgment clarifies conditions under which payments to third-party vendors may or may not constitute a transfer.

iii. **Utilization of funds:** Compliance with Section 7 and Section 8 is vital to ensure funds are utilized for designated purposes and within permissible limits. The Noel Harper judgment establishes parameters for valid fund utilization, including engagement with third-party service providers for mandated activities.

iv. **Administrative cap:** Section 8(1)(b) restricts the utilization of foreign contributions for administrative expenses to 20% of the total amount received in a financial year. Entities exceeding this limit require prior approval from the Central Government.[12]

### Challenges in Current Regulatory Framework

Under the current regulatory framework, several challenges confront entities operating within the ambit of blended finance, particularly concerning compliance with the Foreign Contribution (Regulation) Act (FCRA) alongside other statutes such as the FEMA and state-specific charity laws.

11 Section 7 of FCRA: Prohibition to transfer foreign contribution to other person: No person who: (a) is registered and granted a certificate or has obtained prior permission under this Act; and (b) receives any foreign contribution, shall transfer such foreign contribution to any other person.

12 Section 8 of FCRA: Restriction to utilise foreign contribution for administrative purpose: (1) Every person, who is registered and granted a certificate or given prior permission under this Act and receives any foreign contribution: (a) shall utilise such contribution for the purposes for which the contribution has been received: Provided that any foreign contribution or any income arising out of it shall not be used for speculative business: Provided further that the Central Government shall, by rules, specify the activities or business which shall be construed as speculative business for the purpose of this section; (b) shall not defray as far as possible such sum, not exceeding [twenty per cent] of such contribution, received in a financial year, to meet administrative expenses: Provided that administrative expenses exceeding [twenty per cent] of such contribution may be defrayed with prior approval of the Central Government. (2) The Central Government may prescribe the elements which shall be included in the administrative expenses and the manner in which the administrative expenses referred to in sub-section (1) shall be calculated.

These challenges include:

i. **Complex Regulatory Landscape:** Navigating the intricate provisions of the FCRA, FEMA, and state-specific charity laws poses a significant challenge due to their overlapping and sometimes conflicting requirements. Entities must invest time and resources to understand and comply with multiple regulatory frameworks simultaneously.

ii. **Stringent Criteria for Eligibility:** The FCRA imposes strict eligibility criteria for entities seeking to receive foreign contributions, excluding for-profit entities and alternative investment funds primarily engaged in commercial activities. This restricts access to foreign funding avenues for innovative social enterprises and limits the scope of blended finance initiatives.

iii. **Restrictions on Fund Utilization:** The FCRA delineates permissible activities for entities receiving foreign contributions, emphasizing charitable and developmental initiatives aimed at societal welfare. Restrictions on the utilization of funds derived from commercial activities hinder the flexibility and efficacy of blended finance models in mobilizing resources for social impact projects.

iv. **Approval Process Challenges:** The FCRA's approval process for accepting foreign contributions involves rigorous scrutiny by the Ministry of Home Affairs, reflecting its emphasis on internal security considerations. Entities with foreign nationals on their board of trustees may face heightened scrutiny and potential delays or rejections in FCRA approval, affecting the timely implementation of social impact projects.

v. **Ambiguity in Definitions:** The FCRA does not explicitly define certain terms, such as "Indian origin," leading to reliance on FEMA regulations for guidance. However, inconsistencies in interpretation and internal practices within FCRA authorities may create challenges for organizations with foreign trustees in obtaining registrations and approvals.

vi. **Risk of Non-Compliance:** The FCRA imposes severe penalties for non-compliance, including imprisonment and fines. Entities operating within the blended finance space must ensure meticulous adherence to FCRA guidelines to mitigate the risk of regulatory violations and associated consequences.

## D. Income Tax Act, 1961

In the realm of blended finance, where social enterprises often intertwine commercial activities with charitable endeavors, the applicability of the Income Tax Act, 1961 (**"ITA"**) becomes a crucial consideration. Firstly, income generated from blended finance activities could be subject to taxation under the Act. Whether such income qualifies for exemptions or preferential tax treatment depends on the nature of the entities involved and the specific provisions of the Act applicable to them.

Under Section 11 of the ITA, certain incomes, such as those derived by charitable or religious trusts, may be exempt from taxation. However, to avail of such exemptions, entities engaged in blended finance must satisfy the conditions stipulated in the Act. For instance, they must operate exclusively for charitable or religious purposes and not engage in any activities that generate profits for their members.

Moreover, the ITA provides for tax deductions for donations made to eligible entities engaged in activities deemed beneficial for society. Therefore, donors contributing funds to blended finance initiatives may be eligible for tax benefits under Section 80G of the Act, provided the recipient entity qualifies as a recognized charitable institution.

Section 11 of the ITA extends tax exemptions to charitable organizations, provided their income is wholly utilized for charitable purposes.[13] While the legislative framework allows for commercial activities that are incidental to and supportive of charitable objectives, the practical application has witnessed instances where the tax department has denied the exemptions to organizations engaging in both charitable and commercial pursuits. This disjunction between legal provisions and administrative practice has engendered uncertainty regarding the eligibility for tax exemption in such cases, thereby augmenting the operational costs for social organizations.

Furthermore, Section 11(5) of the ITA[14] permits charitable institutions to accumulate and deploy their income toward specified investments, albeit within a restricted framework. However, these prescribed investment avenues fail to align with the evolving landscape of social entrepreneurship, particularly in the context of Social Impact Funds (SIFs) and innovative investment models. The rigidity of the current investment options inhibits the scalability of non-profits and dissuades them from exploring alternative avenues that could potentially generate both social and financial returns. Many non-profits are concerned that the grants given to a for-profit under the SIF framework, will not be covered under the scope of Charitable Activities as defined under Section 2(15) read with Section 11(5) of the ITA, and the non-profits will in turn risk losing their tax-exempt status.

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13 Section 11(1) of the ITA: Subject to the provisions of sections 60 to 63, the following income shall not be included in the total income of the previous year of the person in receipt of the income: (a) income derived from property held under trust wholly for charitable or religious purposes, to the extent to which such income is applied to such purposes in India; and, where any such income is accumulated or set apart for application to such purposes in India, to the extent to which the income so accumulated or set apart is not in excess of fifteen per cent of the income from such property.

14 Section 11(5) of the ITA: (5) The forms and modes of investing or depositing the money referred to in clause (b) of sub-section (2) shall be the following, namely: (i) investment in savings certificates as defined in clause (c) of section 2 of the Government Savings Certificates Act, 1959 (46 of 1959), and any other securities or certificates issued by the Central Government under the Small Savings Schemes of that Government; (ii) deposit in any account with the Post Office Savings Bank; (iii) deposit in any account with a scheduled bank or a co-operative society engaged in carrying on the business of banking (including a co-operative land mortgage bank or a co-operative land development bank).

Explanation: In this clause, "scheduled bank" means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970), or under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve Bank of India Act, 1934 (2 of 1934); (iv) investment in units of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963); (v) investment in any security for money created and issued by the Central Government or a State Government; (vi) investment in debentures issued by, or on behalf of, any company or corporation both the principal whereof and the interest whereon are fully and unconditionally guaranteed by the Central Government or by a State Government; (vii) investment or deposit in any public sector company: Provided that where an investment or deposit in any public sector company has been made and such public sector company ceases to be a public sector company: (A) such investment made in the shares of such company shall be deemed to be an investment made under this clause for a period of three years from the date on which such public sector company ceases to be a public sector company; (B) such other investment or deposit shall be deemed to be an investment or deposit made under this clause for the period up to the date on which such investment or deposit becomes repayable by such company; (viii) deposits with or investment in any bonds issued by a financial corporation which is engaged in providing long-term finance for industrial development in India and which is eligible for deduction under clause (viii) of sub-section (1) of section 36; (ix) deposits with or investment in any bonds issued by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes and which is eligible for deduction under clause (viii) of sub-section (1) of section 36; (ixa) deposits with or investment in any bonds issued by a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for urban infrastructure in India.

Explanation: For the purposes of this clause: (a) "long-term finance" means any loan or advance where the terms under which moneys are loaned or advanced provide for repayment along with interest thereof during a period of not less than five years; (b) "public company" shall have the meaning assigned to it in section 3 of the Companies Act, 1956 (1 of 1956); (c) "urban infrastructure" means a project for providing potable water supply, sanitation and sewerage, drainage, solid waste management, roads, bridges and flyovers or urban transport; (x) investment in immovable property.

Explanation: "Immovable property" does not include any machinery or plant (other than machinery or plant installed in a building for the convenient occupation of the building) even though attached to, or permanently fastened to, anything attached to the earth; (xi) deposits with the Industrial Development Bank of India established under the Industrial Development Bank of India Act, 1964 (18 of 1964); (xii) any other form or mode of investment or deposit as may be prescribed.

The intricate interplay between profit-driven ventures and altruistic initiatives necessitates a nuanced examination of the tax implications, which often intersect with the eligibility criteria for exemptions and preferential treatment delineated in the Act:

i. **Taxation and Exemptions:** Income generated from blended finance activities may be subject to taxation unless qualifying for exemptions under Section 11 of the ITA. However, securing such exemptions requires meticulous adherence to stringent conditions, including exclusive operation for charitable purposes. The practical application of these provisions has led to uncertainties, as tax authorities sometimes deny exemptions to organizations engaging in both charitable and profit-oriented pursuits.

ii. **Donations and Tax Benefits:** Section 80G of the ITA provides tax deductions for donations made to eligible entities. Nonetheless, ambiguity arises regarding the eligibility of recipients engaged in blended finance initiatives. Clarifications are warranted to ensure donors receive tax benefits and to incentivize contributions to socially impactful projects.

iii. **Investment Restrictions:** Section 11(5) of the ITA restricts the investment avenues available to charitable institutions, hindering their capacity to explore innovative models like Social Impact Funds (SIFs). The rigid framework fails to accommodate the evolving landscape of social entrepreneurship, inhibiting scalability and potentially deterring investment in ventures with dual social and financial objectives.

iv. **Grants to For-Profit Entities:** The prohibition on charities granting funds to for-profit entities poses challenges, as it may jeopardize tax-exempt status for charities and subject for-profits to additional taxation. Amendments to the ITA are necessary to permit tax-exempt grants for furthering charitable objectives through private entities without adverse tax consequences.

v. **Investment Limitations:** Charities are constrained in making investments, thereby restricting their ability to engage in activities beyond grants or fees for engaging for-profit entities. Relaxing these restrictions to allow for debt or equity investments could facilitate sustainable financing models without compromising tax-exempt status.

vi. **80G Certificate Limitations:** The absence of an 80G certificate for many charities impedes their ability to attract funds from donors seeking tax deductions. Extending 80G exemptions to charitable activities facilitated through blended finance transactions would create a level playing field and incentivize philanthropic contributions.

vii. **Special Purpose Vehicles (SPVs) Concerns:** Utilizing charities as SPVs for specific projects raises uncertainties regarding the engagement of third-party service providers and the retention of funds. Clarity from tax authorities and robust disclosure mechanisms are imperative to mitigate risks and ensure compliance with charitable objectives.

## E. Goods and Service Tax

In the context of blended finance, the applicability of Goods and Services Tax (**"GST"**) in India is contingent upon several factors delineated within the Central Goods and Services Tax Act, 2017 (**"CGST Act"**). GST is levied on taxable "supplies" of goods or services, provided by a "taxable person" and it encompasses all forms of supply made for consideration in the course or furtherance of business.

In the realm of GST, the provision of services within blended finance initiatives may attract taxation if they meet the criteria of being a "supply" as per the CGST Act and are offered by a taxable person.

The term "supply" encompasses various transactions, including those made for consideration in the course of or furtherance of business activities, as defined under Section 7(1)(a) of the CGST Act.[15]

Section 2(17) of the CGST Act defines the term "business" to include among others "admission, for a consideration, of persons to any premises".[16] Section 2(107) of the CGST Act defines "taxable person" to mean a person who is registered, or who is liable to be registered under sections 22 or 24 of the CGST Act.[17] The term "person" is defined under section 2(84) of the CGST Act to include all natural and juristic persons, including trusts.[18]

Entities engaging in blended finance endeavors may fall within the purview of GST registration requirements stipulated in Sections 22 and 24 of the CGST Act. Section 22 mandates registration for suppliers exceeding an aggregate turnover threshold of INR 20,00,000 (approx. USD 31,000), while Section 24 mandates compulsory registration for specific categories of suppliers, including non-resident taxable persons, regardless of turnover.[19]

15 Section 7 of CGST. Scope of supply: (1) For the purposes of this Act, the expression "supply" includes (a) all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business.

16 Section 2(17) of CGST Act: 17) "Business" includes: (a) any trade, commerce, manufacture, profession, vocation, adventure, wager or any other similar activity, whether or not it is for a pecuniary benefit; (b) any activity or transaction in connection with or incidental or ancillary to sub-clause (a); (c) any activity or transaction in the nature of sub-clause (a), whether or not there is volume, frequency, continuity or regularity of such transaction; (d) supply or acquisition of goods including capital goods and services in connection with commencement or closure of business; (e) provision by a club, association, society, or any such body (for a subscription or any other consideration) of the facilities or benefits to its members; (f) admission, for a consideration, of persons to any premises; (g) services supplied by a person as the holder of an office which has been accepted by him in the course or furtherance of his trade, profession or vocation; (h) 5[activities of a race club including by way of totalisator or a license to book maker or activities of a licensed book maker in such club; and (i) any activity or transaction undertaken by the Central Government, a State Government or any local authority in which they are engaged as public authorities.

17 Section 2(107) of CGST Act: "Taxable person" means a person who is registered or liable to be registered under Section 22 or Section 24.

18 Section 2(84) of CGST Act: "Person" includes: (a) an individual; (b) a Hindu Undivided Family; (c) a company; (d) a firm; (e) a Limited Liability Partnership; (f) an association of persons or a body of individuals, whether incorporated or not, in India or outside India; (g) any corporation established by or under any Central Act, State Act or Provincial Act or a Government company as defined in clause (45) of section 2 of the Companies Act, 2013 (18 of 2013); (h) any body corporate incorporated by or under the laws of a country outside India; (i) a co-operative society registered under any law relating to co-operative societies; (j) a local authority; (k) Central Government or a State Government; (l) society as defined under the Societies Registration Act, 1860 (21 of 1860); (m) trust; and (n) every artificial juridical person, not falling within any of the above.

19 Section 22 of CGST Act: Persons liable for registration:

(1) Every supplier shall be liable to be registered under this Act in the State or Union territory, other than special category States, from where he makes a taxable supply of goods or services or both, if his aggregate turnover in a financial year exceeds twenty lakh rupees: Provided that where such person makes taxable supplies of goods or services or both from any of the special category States, he shall be liable to be registered if his aggregate turnover in a financial year exceeds ten lakh rupees. [Provided further that the Government may, at the request of a special category State and on the recommendations of the Council, enhance the aggregate turnover referred to in the first proviso from ten lakh rupees to such amount, not exceeding twenty lakh rupees and subject to such conditions and limitations, as may be so notified.] [Provided also that the Government may, at the request of a State and on the recommendations of the Council, enhance the aggregate turnover from twenty lakh rupees to such amount not exceeding forty lakh rupees in case of supplier who is engaged exclusively in the supply of goods, subject to such conditions and limitations, as may be notified.

Explanation: For the purposes of this sub-section, a person shall be considered to be engaged exclusively in the supply of goods even if he is engaged in exempt supply of services provided by way of extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount.]

(2) Every person who, on the day immediately preceding the appointed day, is registered or holds a licence under an existing law, shall be liable to be registered under this Act with effect from the appointed day.

(3) Where a business carried on by a taxable person registered under this Act is transferred, whether on account of succession or otherwise, to another person as a going concern, the transferee or the successor, as the case may be, shall be liable to be registered with effect from the date of such transfer or succession.

(4) Notwithstanding anything contained in sub-sections (1) and (3), in a case of transfer pursuant to sanction of a scheme or an arrangement for amalgamation or, as the case may be, demerger of two or more companies pursuant to an order of a High Court, Tribunal or otherwise, the transferee shall be liable to be registered, with effect from the date on which the Registrar of Companies issues a certificate of incorporation giving effect to such order of the High Court or Tribunal.

Explanation: For the purposes of this section, (i) the expression "aggregate turnover" shall include all supplies made by the taxable person, whether on his own account or made on behalf of all his principals; (ii) the supply of goods, after completion of job work, by a registered job worker shall be treated as the supply of goods by the principal referred to in section 143, and the value of such goods shall not be included in the aggregate turnover of the registered job worker; (iii) the expression "special category States" shall mean the States as specified in sub-clause (g) of clause (4) of article 279A of the Constitution [except the State of Jammu and Kashmir] [and States of Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya, Sikkim and Uttarakhand].

Non-resident taxable persons, as defined under Section 2(77) of the CGST Act, refer to individuals or entities undertaking occasional transactions involving the supply of goods or services in India without a fixed place of business or residence. Such entities are obligated to register for GST.

However, certain activities conducted by not-for-profit organizations may be exempt from GST as per government circulars.[20] Nonetheless, for-profit entities offering services within blended finance frameworks are generally subject to GST at applicable rates unless specifically exempted.

## F. Foreign Direct Investment

Under the FDI regime, investment is primarily channelled into equity shares, fully and compulsorily convertible preference shares (CCPS) and fully and compulsorily convertible debentures (CCDs). These instruments provide avenues for foreign investors to participate in the governance and risk-based returns of Indian companies. Equity shares entitle investors to governance rights and participation in company profits through dividends, which are subject to taxation. Conversely, CCPS and CCDs offer fixed returns, typically in the form of dividends or interest, irrespective of company profits. The taxation implications of CCPS and CCDs differ from equity shares, with interest expenses being deductible and withholding tax varying based on jurisdiction.

In this context, the FDI regime offers avenues for foreign investors to engage in financing mechanisms that support sustainable development goals. By investing in equity shares, CCPS, or CCDs of Indian companies operating in sectors aligned with sustainable development objectives, foreign investors can contribute to initiatives addressing environmental, social, and governance (**ESG**) considerations. Furthermore, the FDI regime allows for investment in startups and infrastructure projects, offering opportunities for blended finance structures to support innovative solutions and critical infrastructure development.

Importantly, the FDI regime imposes stringent valuation requirements, ensuring transparency and protection of Indian companies, particularly Small and Medium Enterprises (SMEs), from undervaluation or external capital stripping. Additionally, the regime stipulates statutory liquidation preferences, safeguarding the interests of investors in the event of company liquidation.

Blended finance initiatives leveraging the FDI regime must navigate regulatory requirements, including compliance with Securities and Exchange Board of India (SEBI) regulations and restrictions on investible funds. However, the flexibility offered by the FDI regime, particularly through avenues such as Foreign Venture Capital Investment, presents opportunities for innovative financing structures tailored to address specific development challenges.

20 For specific activities carried out by not for profits that are exempt from GST, please refer to Annexure () which is the Government circular issued in relation to the same.

# G. External Commercial Borrowing

Direct loans by offshore risk investors are subject to conditionalities under the FPI and External Commercial Borrowings (**'ECBs')** framework in India. As per Regulation 2(iv) of the FEMA (Borrowing and Lending) Regulation,2018 *"external commercial borrowing"* means borrowing by an eligible resident entity from outside India in accordance with framework decided by the Reserve Bank in consultation with the Government of India. The minimum maturity period under the ECB regime ranges from 3 to 5 years depending on the end use.

ECB offers a structured avenue for Indian corporates to access foreign funds, aligning with the objectives of blended finance to catalyze sustainable development projects. Under ECB regulations, entities eligible to receive Foreign Direct Investment (FDI) can avail themselves of foreign currency denominated ECB (FCY ECB), while microfinance entities, including registered not-for-profits, NGOs, and Section 8 companies, among others, can access INR denominated ECB (INR ECB). This broad eligibility spectrum enables a diverse range of organizations to participate in blended finance arrangements.

Furthermore, ECB allows for participation from residents of countries compliant with FATF or IOSCO standards, expanding the pool of potential lenders. Foreign equity holders, holding either direct or indirect stakes in the borrower, are also eligible to lend under the ECB framework, facilitating cross-border investment in blended finance projects.

However, despite its potential, ECB in the context of blended finance faces several challenges:

i. **Regulatory Constraints on End-Use:** The ECB framework imposes stringent regulatory restrictions on the end-use of borrowed funds, limiting the flexibility of utilizing capital for blended finance projects. These constraints, although intended to ensure responsible borrowing practices, may inadvertently hinder the scope and diversity of eligible projects, thereby constraining the potential impact of blended finance in sustainable development.

ii. **Minimum Maturity Period Requirement:** The prescribed minimum maturity period for ECB, ranging from 3 to 5 years depending on the end-use, poses a significant challenge in aligning financing timelines with the needs of development projects. Particularly for initiatives in the realm of charitable work, where immediate funding may be imperative for addressing pressing societal needs, the extended maturity period may be incompatible with the urgency of action, thereby complicating financing arrangements.

iii. **Complex Regulatory Landscape:** The intricate regulatory landscape governing ECB transactions, coupled with compliance requirements, presents a formidable barrier for potential participants, especially smaller organizations or those with limited exposure to international financing mechanisms. The complexity of regulations may deter eligible entities, including non-profit organizations, from engaging in blended finance endeavors, thereby stifling innovation and collaboration in the sector.

iv. **Ambiguity in Eligibility Criteria:** Ambiguity persists regarding the eligibility of non-profit entities, beyond microfinance institutions (MFIs), to receive funding under the ECB framework. While the regulations ostensibly extend eligibility to entities involved in charitable work, the practical application and interpretation of these provisions remain unclear. This ambiguity creates uncertainty for non-profit organizations seeking to access financing for their initiatives, potentially hampering the flow of capital into critical social impact projects.

v. **Currency Exchange Risks:** The inherent currency exchange risks associated with foreign currency-denominated ECB transactions pose a significant concern for project viability and financial sustainability, particularly in the context of blended finance models. Fluctuations in exchange rates could adversely affect the repayment obligations of borrowers, necessitating robust risk management strategies to mitigate potential losses and ensure the long-term success of financed projects.

## H. FEMA

In the context of blended finance, where foreign non-profits seek to establish social enterprises in India, the applicability of FEMA is of paramount importance. FEMA governs investments into India, including the establishment of wholly owned subsidiaries (WOS) by foreign entities and ensures compliance with regulations such as the e Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (**"NDI Rules"**).

Under FEMA, as per Section 2(u) of the Act, the definition of 'person' encompasses various entities, including individuals, companies, firms, associations of persons, and artificial juridical persons. It also includes agencies, offices, or branches owned or controlled by such entities.[21] Similarly as per Section 2(v) of the FEMA defines a 'Person resident in India' as an individual residing in India for more than 182 days during the preceding financial year, along with other criteria specifying residency status.[22]

Conversely, Section 2(w) defines a 'Person resident outside India' refers to an entity not meeting the criteria for residency in India.[23] However, such entities can still invest in Indian companies within the limits and conditions specified in the NDI Rules.

For foreign non-profits intending to establish WOS in India, they are regarded as body corporates registered outside India. Therefore, they can set up subsidiaries in India within the framework of the existing FDI Scheme, subject to applicable laws, regulations, and specified conditions.

21 Section 2(u) of FEMA: (u) "Person" includes: (i) an individual, (ii) a Hindu undivided family, (iii) a company, (iv) a firm, (v) an association of persons or a body of individuals, whether incorporated or not, (vi) every artificial juridical person, not falling within any of the preceding sub-clauses, and (vii) any agency, office or branch owned or controlled by such person.

22 Section 2(v) of FEMA: (v) "Person resident in India" means: (i) a person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year but does not include: (A) a person who has gone out of India or who stays outside India, in either case: (a) for or on taking up employment outside India, or (b) for carrying on outside India a business or vocation outside India, or (c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period; (B) a person who has come to or stays in India, in either case, otherwise than: (a) for or on taking up employment in India, or (b) for carrying on in India a business or vocation in India, or (c) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period; (ii) any person or body corporate registered or incorporated in India, (iii) an office, branch or agency in India owned or controlled by a person resident outside India, (iv) an office, branch or agency outside India owned or controlled by a person resident in India.

23 Section 2(w) of FEMA: (w) "person resident outside India" means a person who is not resident in India.

# I. IFSCA (Fund Management) Regulations, 2022

The emergence of blended finance models has become increasingly prominent in the financial landscape, particularly in the realm of social impact investment. The Gujarat International Finance Tec-City (**"GIFT City"**) International Financial Services Centre (**"IFSC"**) has established regulatory frameworks to accommodate such innovative approaches. This paper delves into the regulatory landscape provided by the IFSC Authority (**"IFSCA"**) Fund Management Regulations, 2022 (**"FM Regulations"**) concerning blended finance models within the GIFT IFSC:

i. **Fund Management Entity (FME) Registration:** Under the purview of the FM Regulations, any entity aspiring to launch a social impact fund within the GIFT IFSC must obtain registration as a Registered FME (non-retail).[24]. These entities can be structured as Limited Liability Partnerships (LLPs) or Companies.[25] However, due to the inherent flexibility and reduced regulatory burden, FMEs are often established as LLPs.

ii. **Restricted Schemes and Investment Vehicles:** Registered FMEs (non-retail) have the liberty to establish Restricted Schemes (non-retail)[26] which can be structured as LLPs, Trusts, or Companies.[27] These schemes cater to investment strategies aimed at fostering social impact, including support for startups and social ventures.[28] Such schemes are required to register under the category of Category I Alternative Investment Funds (CAT-I AIFs), as mandated by the FM Regulations.

iii. **Compliance with FEMA Regulations:** Given the international nature of transactions within the GIFT IFSC, compliance with the Foreign Exchange Management Act (FEMA) is imperative. Notably, investments made by social impact funds domiciled in the GIFT IFSC into Indian companies are subject to the FEMA (Non-debt Instruments) Rules, 2019. These regulations stipulate conditions such as sectoral caps, pricing guidelines, and entry routes as prescribed in Schedule I of the NDI Rules.

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24 Regulation 3(4)(b), FM Regulations: Registered FME (Non-Retail): The FMEs that pool money from accredited investors or investors investing above a specified threshold by way of private placement for investing in securities, financial products and such other permitted asset classes through one or more restricted schemes. Such FMEs shall also be able undertake Portfolio Management Services (including for multi-family office) and act as investment manager for private placement of Investment Trust (REITs and InvITs). Such FMEs shall also be able to undertake all activities as permitted to Authorised FMEs.

25 Regulation 33(3), FM Regulations: (3) Restricted schemes shall be constituted in IFSC as Company or LLP or Trust under the applicable laws of India.

26 Regulation 3(4)(b), FM Regulations: Registered FME (Non-Retail): The FMEs that pool money from accredited investors or investors investing above a specified threshold by way of private placement for investing in securities, financial products and such other permitted asset classes through one or more restricted schemes. Such FMEs shall also be able undertake Portfolio Management Services (including for multi-family office) and act as investment manager for private placement of Investment Trust (REITs and InvITs). Such FMEs shall also be able to undertake all activities as permitted to Authorised FMEs.

27 Regulation 33(3), FM Regulations: (3) Restricted schemes shall be constituted in IFSC as Company or LLP or Trust under the applicable laws of India.

28 Regulation 30(1)(a), FM Regulations: (a) investing in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME Funds, social venture funds, infrastructure funds, ESG Funds, Special Situation funds (as detailed in Part D of this Chapter) and such other Schemes/Funds as may be specified by the Authority. Schemes falling under this clause shall be a close ended scheme and filed before the Authority as Category I Alternative Investment Fund.

Explanation I: The Scheme may be construed as Category I Alternative Investment Fund as referred under the Income Tax Act, 1961, the Foreign Exchange Management Act, 1999 or rules, regulations, circulars, notifications, guidelines etc. under the respective Acts or any other relevant statute.

Explanation II: Venture capital funds under this Part shall not be required to comply with conditions specified for venture capital schemes as provided under Part A of Chapter III of these regulations.

# Section 3

# Structures

## A. Gift Structure

GIFT IFSC stands as a beacon of India's aspirations to become a global financial hub. Located in the vibrant state of Gujarat, Gift City epitomizes innovation and ambition in the financial sector. One of the most promising aspects of GIFT IFSC is its embrace of blended finance models, which offer a unique approach to funding and investment. In the context of GIFT IFSC, blended finance models can serve as a catalyst for attracting investment in infrastructure, technology and sustainable development initiatives.

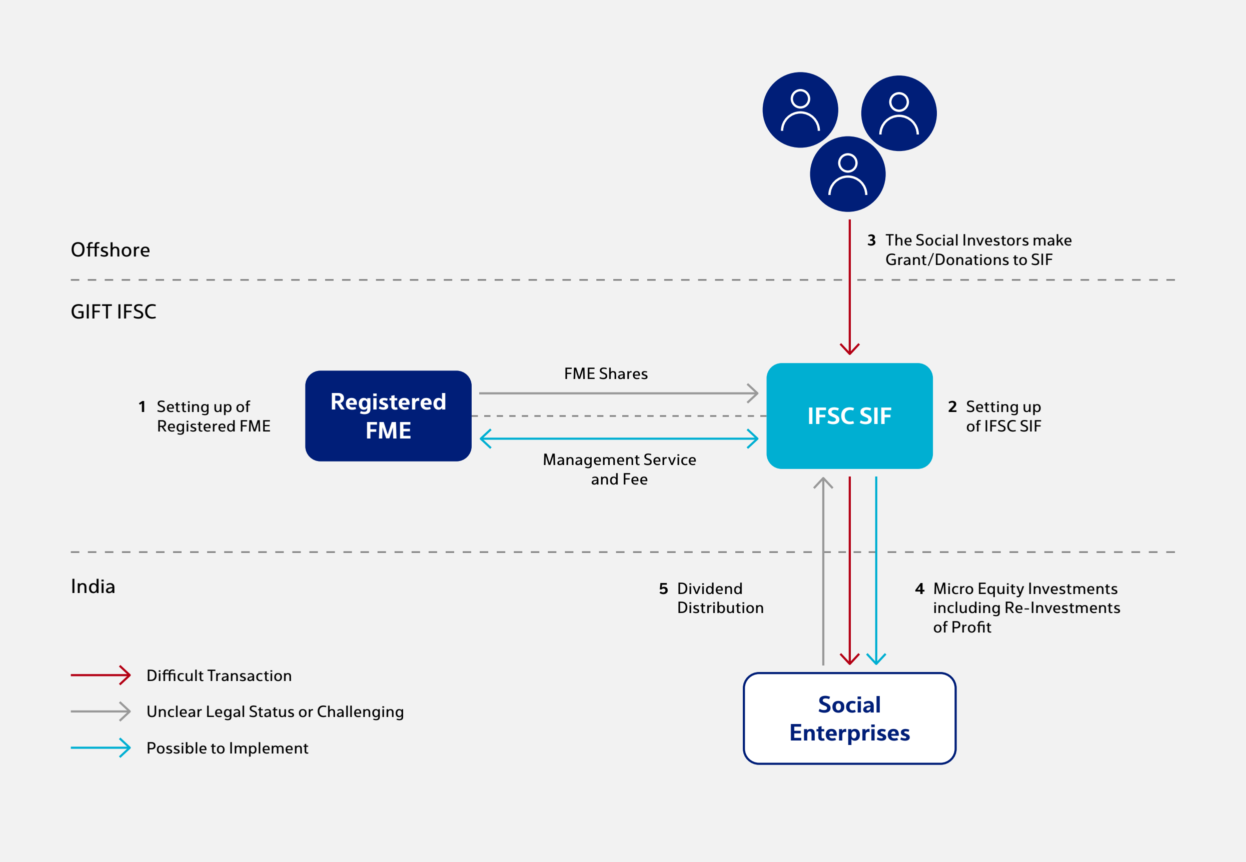


*Figure 4 – GIFT Structure Model.*

The rural entrepreneurs often encounter significant obstacles in raising adequate funds to establish and grow their businesses, particularly within the competitive market landscape. The traditional debt-driven schemes, though prevalent in the market are generally debt-driven to minimize the risk factors, which include interest subvention, subsidy, credit guarantee through schemes such as PMEGP, MUDRA, Start-up India etc. These schemes instead of solving the problem, impose heavy burden on these entrepreneurs, exacerbating their financing struggles and hindering their ability to thrive.

In response to this, the GIFT IFSC Structure model set out below (Figure 4), tries to explore the regulatory ecosystem of GIFT IFSC to address the root cause of rural economic disparities. Central to the model is the establishment of a SIF within GIFT IFSC as per the FM Regulations, designed to provide institutional incubation and micro-equity funding to these rural social enterprises (**"Social Enterprise"**). Unlike conventional debt financing, which places undue pressure on entrepreneurs, the SIF adopts a holistic approach, offering perpetual and non-returnable investments that prioritize the long-term sustainability and empowerment of rural communities.

The proposed blended finance model in GIFT IFSC involves the establishment of a SIF as a Category-I AIF in GIFT IFSC, that will be managed by the Registered FME. The SIF will act as a pooling vehicle for philanthropic grants and private investments, which will be strategically deployed to invest in Social Enterprises operating in rural areas in India. It is pertinent to mention here that the investments made by the SIF in the village enterprises shall be on a perpetual and non-returnable basis, where the ownership shall be vested in the Social Enterprise that will be holding the maximum sweat equity.

The SIF will be accepting the investments/ grants/ donations from offshore philanthropic organisations/ donors and then making downward investments into the Social Enterprises. Such investments are intended to have moderate economic returns.

Furthermore, returns generated are intended to be reutilized on a perpetual revolving basis. No returns are expected to be received by the offshore philanthropies / donors making investments / grants to the SIF.

**Key Steps**

i. The non-profit will first set up a registered FME in GIFT IFSC as per the FM Regulations. The FME shall obtain registration and meets specified conditions, including minimum net worth and substance requirements as per the FM regulations.

ii. The SIF shall then be incorporated as a Restricted Scheme (non-retail) under the FME, registered as a Category-I AIF as per the FM Regulations. The SIF aims to invest in Social Enterprises with social impact objectives.

iii. The SIF shall receive grants from offshore philanthropic and private donors.

iv. Th SIF shall be utilising the pooled money to make micro-equity investments in the Social Enterprises in rural areas in India.

v. Returns from the Social Enterprises shall be reutilised to fund other Social Enterprises.

vi. No return shall be paid to the offshore philanthropic organisations and / or private donors.

## Key Challenges

| SN | Step | Issue |
|---|---|---|
| 1 | **Step 1**<br>**SIF shall form an FME as per FM Regulations** | Under the FM Regulations, an FME can only be set up as a Company or LLP. While the FME will be able to get 100% tax deduction from gross total income arising from management fee. However, if the FME is set up as an LLP a 9% AMT and similarly for Company a 9% MAT will be applicable unless the FME opts for the concessional tax regime under Section 115BAA of the ITA.<br>In the event that the FME is set up as a company, distributions by way of dividends to resident shareholders should be subject to tax at their applicable slab rate. Dividend distributions to non-resident shareholders should be subject to a 10% withholding tax for which credit in the overseas jurisdiction may be available subject to relevant tax treaty applicability. However, distributions made to partners of an LLP should not be subject to any further taxation. |
| 2 | **Step 2**<br>**The SIF shall then be incorporated as a Restricted Scheme (non-retail) under the FME, registered as a Category-I AIF as per the FM Regulations.** | Incorporating the SIF as a for-profit entity may lead to operational complexities, especially concerning receiving grants or donations from offshore philanthropies or private donors. Offshore donors typically have end use restrictions whereby they can only donate / provide grants to foreign organisations which qualify as public charities if they want to ensure tax equivalency.<br>Section 56(2)(x) of the ITA imposes tax on sums exceeding INR 50,000 received without consideration. The issuance of equity shares as consideration may raise concerns regarding tax implications, especially if the investors do not receive returns.<br>The requirement for social venture funds to be close-ended may conflict with the commercial objective of the SIF, which aims for perpetual operation. |
| 3 | **Step 3**<br>**The SIF shall receive grants from offshore philanthropic and private donors.** | The practical implementation of tax pass-through status under Section 115UB given the commercial intention of not providing returns to investors, poses uncertainty and may require clarification.<br>While typically a Section 8 Company receiving foreign contributions must seek FCRA registration, the nature of grants received by the SIF may not strictly fall under the definition of foreign contributions leading to lot of uncertainty and ambiguity on its applicability. |
| 4 | **Step 4**<br>**The SIF uses the pooled money to make micro-equity investments in the village enterprises in rural areas in India.** | As the SIF is treated as a non-resident for FEMA purposes, investments in Indian companies must adhere to the NDI Rules. Compliance with sectoral caps, pricing guidelines and entry routes prescribed in the NDI Rules is essential. |

Despite the legal and regulatory challenges, the implementation of a blended finance model in GIFT IFSC presents significant opportunities for mobilizing capital towards social impact objectives. By addressing these challenges through strategic planning, regulatory compliance and stakeholder engagement, non-profit organisations can unlock the potential of the GIFT IFSC to drive economic growth and social transformation.

## B. Outcome-Based Funding

In India, a pressing issue in education is the stark inequality in access to quality learning, particularly among underprivileged communities. To address this issue the proposed model (*Figure 5*) aims to mobilize resources from private charities and public organizations, both domestically and internationally, to target specific regions in India.

The model operates through two main pathways: Impact Bonds (IB) and an ed-tech accelerator (Accelerator), employing an outcome-based financing approach. Initially, Offshore risk investors will be providing upfront working. capital to the for-profit Special Purpose Vehicle (SPV) set up in an Offshore jurisdiction (**"Investor SPV"**). This offshore entity will then transfer the funds in the form of Grants to the Implementing Agencies (IAs), responsible for executing the project on the ground, focusing on improving foundational literacy and numeracy skills among underprivileged children.

Coordinating the various stakeholders involved, a Transaction Manager will oversees the project's execution and will be receiving funding from Offshore Outcome Funders. The Outcome Funder (both International and Domestic) will disburse the Achievement Payments to the Investor SPV based on Assessment Reports submitted by independent assessors/verifiers. CSR funders will be directly transferring their CSR contributions to the IAs based on pre-agreed criteria, ensuring streamlined resource allocation.

Lastly, to ensure effective program delivery and accountability, a dedicated Performance Manager will be appointed to supports execution and reporting activities of the project.

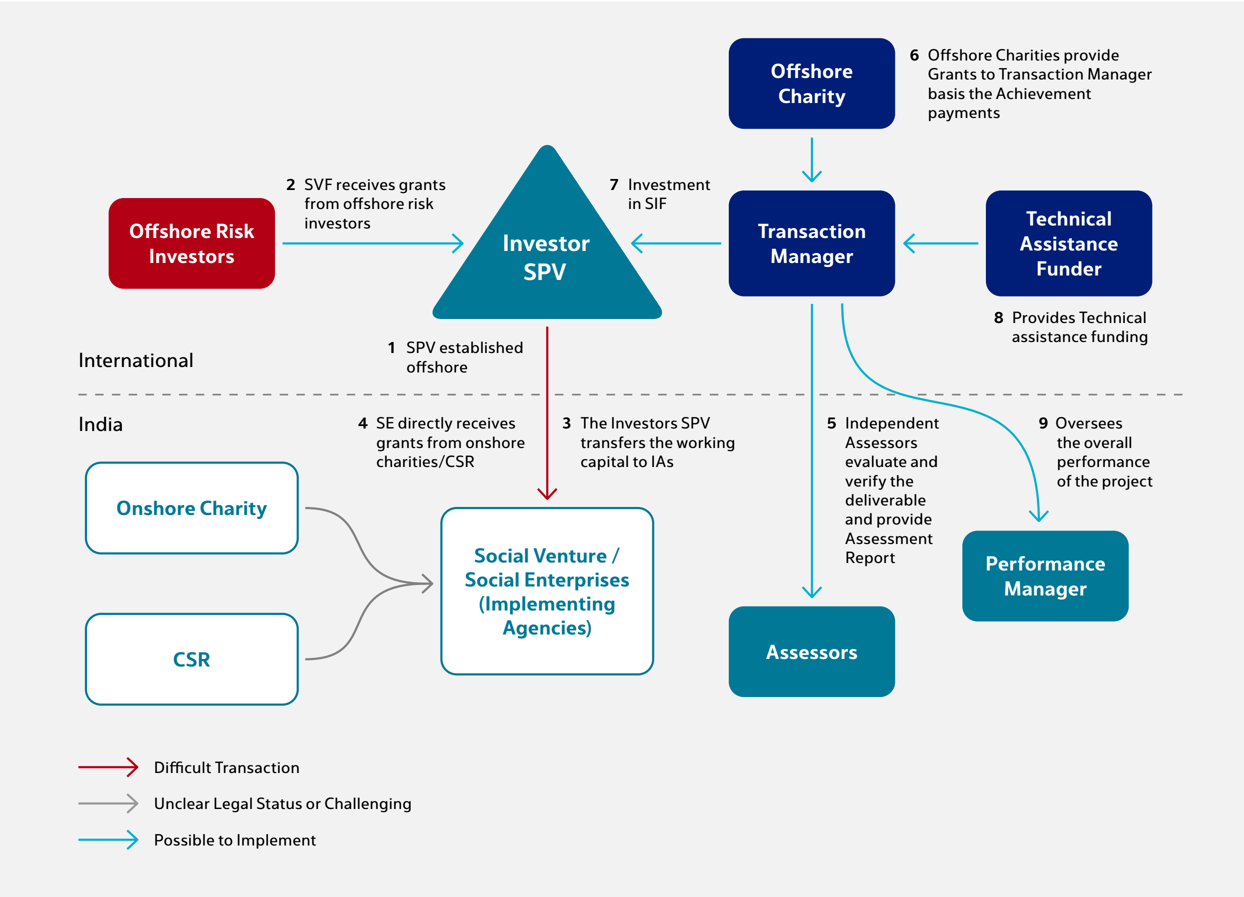


*Figure 5 – Outcome Based Model.*

**Key Steps**

i. The SPV will be established to manage the funds and oversee the implementation of the project.

ii. Offshore risk investors will provide upfront working capital to the SPV, which acts as a for-profit entity situated outside India.

iii. The Investor SPV will distribute the funds received from risk investors to the selected IAs responsible for executing the literacy and numeracy project on the ground.

iv. The Transaction Manager will be appointed to coordinate the project among all stakeholders, including risk investors, outcome funders, IAs, evaluators, and technical assistance funders.

v. On the completion of the milestones as mutually agreed by the parties the independent evaluator will evaluate and verify the targets achieved by the IA and basis which he will issue an Assessment Report to the Transaction Manager.

vi. The Transaction Manager shall then send the Assessment Reports to the Outcome Funders and basis the Assessment Report, the Outcome Funders will disburse the Achievement Payments to the IAs. While the offshore outcome funders make contributions to the Transaction Manager who will be then transferring the funds to the Investor SPV to be given to the IAs for the implementation of the project. The onshore outcome funders will be directly making their contributions to the IAs, basis the pre-agreed criteria determined by the parties.

vii. The SPV will use Achievement Payments to cover further implementation payments to the IAs, ensuring continuity of the project.

viii. A Performance Manager will be appointed to support program execution and aid in reporting activities, ensuring effective delivery of the program and accountability.

## Key Challenges

| SN | Step | Issue |
|---|---|---|
| 1 | Step 3<br>**The Investor SPV will distribute the funds received from risk investors to the selected IAs responsible for executing the literacy and numeracy project on the ground** | The Indian non-profits are governed by the stringent FCRA restrictions where only entities that have FCRA registrations can receive grants / foreign contributions from offshore funders/ donors.<br>Furthermore, Section 7 of the FCRA prohibits sub-granting, regardless of the FCRA registration status of the third-party and any violation of this section, may lead to cancellation of FCRA license of the IA.<br>In case of receiving public funding, receiving outcome funding by the government in a specific structure such as this may be subject to tender process and government procurement rules when it comes to contracting with entities. |

## C. First-Loss Guarantee Model

The First-loss Guarantee/Loan Support Model (Figure 6) presents a compelling solution to the financing challenges faced by Micro, Small, and Medium Enterprises (**"MSMEs"**) and the agriculture sector, particularly in economies like India. These sectors are crucial drivers of economic growth, employment generation, and food security, yet they often struggle to access affordable capital. In response, this model leverages capital from various sources, including commercial investors, charitable organizations, and corporate social responsibility (CSR) entities, to provide low-cost loans to MSMEs and farmers.

At its core, the model operates by mobilizing capital from investors, both onshore and offshore, who contribute funds to Non-Banking Financial Companies (**"NBFCs"**). Simultaneously, onshore charitable organizations or CSR entities allocate a portion of their capital to these NBFCs, entering into first-loss arrangements. These agreements serve as a safeguard, ensuring that in the event of borrower default, the charitable entities cover part or all of the losses incurred by the NBFCs.

With the capital in place, NBFCs can then disburse loans tailored to the specific needs of MSMEs and farmers, whether it's for working capital or agricultural inputs. By leveraging capital from diverse sources and implementing risk mitigation mechanisms, NBFCs are able to offer loans at lower interest rates compared to traditional financial institutions. This affordability enhances accessibility to finance, supporting the growth and development of MSMEs and the agriculture sector. Upon successful repayment of loans, returns are distributed to risk investors, and capital is returned to charitable organizations or CSR entities.

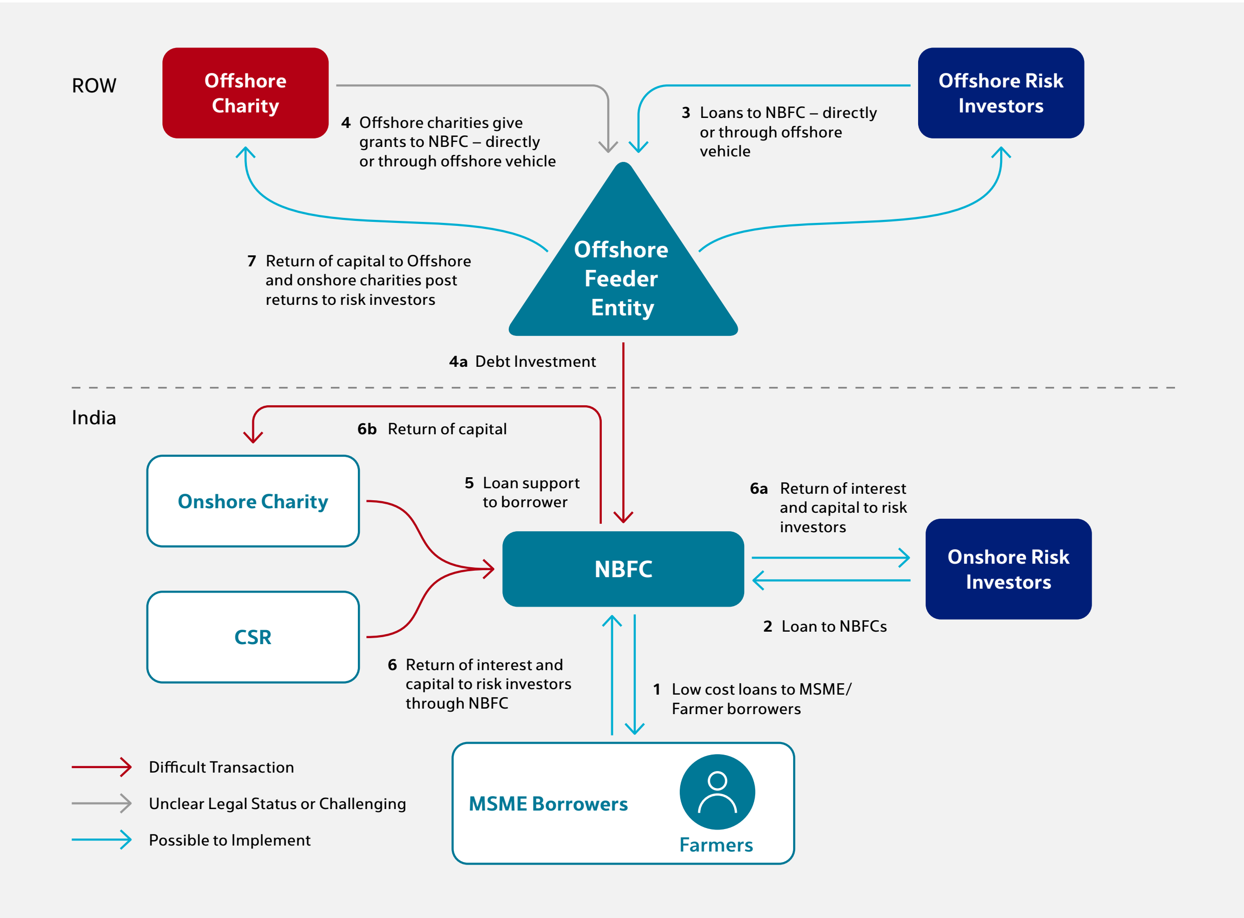


*Figure 6 – First-Loss Guarantee Model.*

### Key Steps

i. The NBFC disburses low-cost loans to MSMEs and farmers, assessing applications and establishing loan agreements.

ii. Onshore investors allocate capital to the NBFC, enhancing its lending capacity and supporting its mission.

iii. Offshore investors contribute capital either directly or through pooling vehicles to fund the NBFC's lending activities.

iv. Offshore charities provide funding to the NBFC, supplementing its capital base and promoting financial inclusion.

v. Onshore charitable entities deploy funds to the NBFC and establish first-loss arrangements to mitigate lending risks.

vi. Loan repayments from MSMEs/farmers are collected by the NBFC and distributed to investors based on predefined arrangements.

vii. After investor distributions, remaining capital is returned to onshore and offshore charitable organizations, ensuring sustainability and accountability.

## Key Challenges

| SN | Step | Issue |
|---|---|---|
| 1 | **Step 3**<br>**Offshore investors contribute capital either directly or through pooling vehicles to fund the NBFC's lending activities.** | ▪ Direct loans by offshore risk investors to NBFCs face conditionalities under the ECBs and FPI frameworks, including minimum maturity periods and registration requirements.<br>▪ Obtaining an FPI registration and complying with a 3-year minimum maturity period, when the goal is to provide immediate liquidity during the period of the crisis, is not feasible.<br>▪ Therefore, in step 3, an offshore pooling vehicle may become necessary to pool offshore money, to provide flexibility to offshore investors to manage investment timelines. However, this increases transaction costs and partly addresses the challenge that mandates a minimum 3-year holding period. |
| 2 | **Step 4**<br>**Offshore charities provide funding to the NBFC, supplementing its capital base and promoting financial inclusion.** | ▪ Grants from offshore charities to NBFCs are restricted by FCRA, which prohibits for-profit entities from receiving offshore grants. While the FCRA governs utilization of grants and foreign contribution to entities in India, it is silent on its applicability to for-profit entities.<br>▪ Furthermore, in the event that a for-profit is still able to receive grants/ donations from offshore charities, the NBFC will still not be able to deploy it further, due to the sub-granting prohibition under FCRA. |

| SN | Step | Issue |
|---|---|---|
| 3 | **Step 5**<br>**Onshore charitable entities deploy funds to the NBFC and establish first-loss arrangements to mitigate lending risks.** | The first-loss arrangement between onshore charitable organizations/CSR entities and NBFCs raises concerns about compliance with the ITA and CSR laws. There is ambiguity regarding whether such arrangements qualify as charitable spending, under the relevant legislations.<br>Under the current regime the CSR laws do not provide a regime to utilise CSR money to provide first loss. This means that if the CSR paid the money as a grant to a farmer or MSME and then the farmer or MSME paid back the loan to the NBFC, that is acceptable under current laws. However, today, in a complex world, it is impossible to achieve this on a large scale due to the number of transactions, documents and compliances required. It would be easier to achieve the same result by enabling a direct firstloss payment by the CSR to the NBFC. As long as the same end result is achieved, it should not be viewed as a violation of the spirit of CSR |
| 4 | **Step 6**<br>**Loan repayments from MSMEs/ farmers are collected by the NBFC and distributed to investors based on predefined arrangements.** | Repayment of grants to charitable organizations by NBFCs may encounter tax, accounting, and FEMA issues. There are legal restrictions on NBFCs making grants, and clarity is lacking regarding the treatment of such repayments. |

In summary, while the First-loss guarantee/loan support model holds potential to address the capital needs of MSMEs and farmers, navigating the legal and regulatory landscape is crucial to ensure its effectiveness and compliance with applicable laws.

## D. Social Impact Fund Model

SIFs play a pivotal role in addressing pressing social and economic challenges, particularly in regions where traditional financial mechanisms fall short. By leveraging blended finance structures, SIFs facilitate the deployment of capital towards impactful projects while mitigating risks for investors (Figure 7). In emerging economies like India, where access to finance is a significant barrier for MSMEs and agricultural sectors, SIFs hold immense relevance in catalysing inclusive growth and sustainable development.

The operational flow of a SIF typically involves the aggregation of capital from various sources, strategic deployment of funds into high-impact projects, and mechanisms for risk mitigation and returns distribution. One effective model is the Specialized Vehicle Fund (SVF) structure, which optimizes the scale of impact and attracts capital from diverse stakeholders. The SVF model integrates both philanthropic and private capital, channelling resources towards critical sectors such as MSMEs and agriculture.

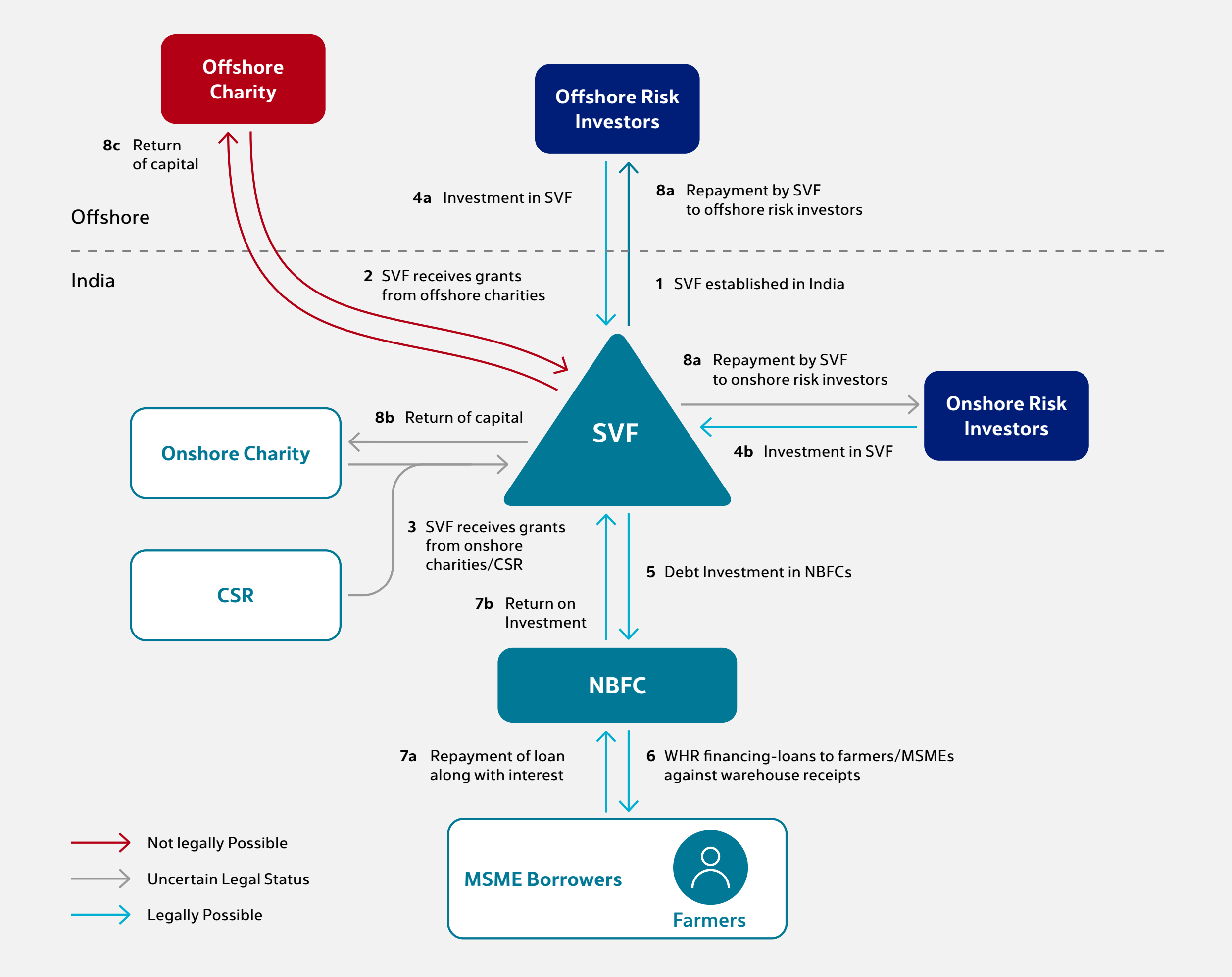


*Figure 7 – Social Impact Fund Model.*

## Key Steps

i. A SVF is established, pooling investments from onshore and offshore risk investors. These investors receive units in the SVF, entitling them to normal returns and potential dividends.

ii. The SVF secures grants from offshore charities and onshore CSR entities, enhancing its capital pool for investment.

iii. Utilizing the pooled capital, the SVF makes debt investments in one or more NBFCs specializing in lending to MSMEs and Farmer Producer Organizations FPOs.

iv. The NBFCs extend loans to MSMEs and FPOs against warehouse receipts, providing vital financial support to these underserved sectors.

v. Returns generated from the loans are channeled back to the NBFCs, which subsequently distribute profits to the SVF investors, including risk investors and grant providers.

vi. In case of loan defaults or losses, the SVF utilizes the grant funds received from charities to compensate risk investors up to a predefined limit, minimizing investment risks.

vii. Upon successful recovery of loans, the SVF may repay grants to the charities, demonstrating financial sustainability and impact effectiveness. Additionally, ongoing monitoring and evaluation mechanisms assess the social and economic impact generated by the investments.

## Key Challenges

| SN | Step | Issue |
|---|---|---|
| 1 | **Step 2**<br>**The SVF secures grants from offshore charities and onshore CSR entities, enhancing its capital pool for investment.** | ▪ Once the SVF is established and ready to receive grants, it encounters a significant hurdle. Offshore charities, despite their willingness to contribute, are bound by stringent FCRA restrictions. Only entities with FCRA registration can legally receive offshore grants. However, FCRA registrations are typically not granted to for-profit entities like the SVF. This legal barrier obstructs the flow of offshore grants, impeding the SVF's ability to provide low-cost loans or compensate risk investors in case of losses.<br>▪ Furthermore, in the event the SIF is allowed to receive foreign contribution, it will still not be able to deploy its funds further, due to the prohibition on sub-granting as per Section 7 of the FCRA.<br>▪ Grants by charities to for-profits entities could be taxed as income from other sources, although there are some tribunal judgments that state similar receipts could be treated as non-taxable capital receipts. Charities are concerned that grants to private entities such as an SVF may not be considered as a charitable spend. If it is not a charitable spend, the charity risks losing its tax-exempt status. |
| 2 | **Step 3**<br>**Utilizing the pooled capital, the SVF makes debt investments in one or more NBFCs specializing in lending to MSMEs and Farmer Producer Organizations FPOs.** | Existing regulations do not permit SVFs to invest in debt instruments of entities, posing a legal barrier to the planned investment strategy. This regulatory constraint limits the SVF's ability to deploy its capital effectively, hindering its mission to support MSMEs and Farmer Producer Organizations (FPOs). |
| 3 | **Step 5**<br>**Returns generated from the loans are channeled back to the NBFCs, which subsequently distribute profits to the SVF investors, including risk investors and grant providers.** | In the event of loan defaults or losses, the SVF faces challenges in utilizing the received grants to compensate risk investors. Existing SVF regulations mandate that 100 percent of grants received must be invested into downstream entities, prohibiting direct compensation to risk investors. This regulatory limitation complicates the risk management framework of the SVF, impeding its ability to safeguard investor interests. |
| 4 | **Step 7**<br>**Upon successful recovery of loans, the SVF may repay grants to the charities, demonstrating financial sustainability and impact effectiveness. Additionally, ongoing monitoring and evaluation mechanisms assess the social and economic impact generated by the investments.** | Upon successful recovery of loans, the SVF encounters legal hurdles in repaying grants to charities. Repayment to onshore charities poses a risk of jeopardizing their tax-exempt status, as it may be perceived as engaging in for-profit activities, which is prohibited by law. Similarly, repayment to offshore charities faces logistical challenges, as returns from downstream investments are earmarked for distribution to unit holders, precluding their use for grant repayment. Such legal and regulatory complexities constrain the SVF's ability to fulfil its obligations and maintain financial sustainability. |

# Conclusion

In navigating the complexities of scaling blended finance solutions, it becomes evident that the path forward requires a comprehensive and detailed approach. While acknowledging the challenges entrenched within the legal and regulatory frameworks, it is imperative to delineate a nuanced strategy that addresses each obstacle systematically.

## Challenges

i. **High cost of structuring:** The intricacies involved in structuring blended finance transactions significantly escalate costs. The absence of standardized models exacerbates this challenge, rendering many initiatives economically unviable.

ii. **Lack of templatized models:** The absence of templatized models stems from regulatory inhibitions that restrict the blending of different capital sources. This lack of flexibility impedes the development and scaling of blended finance solutions.

iii. **Difficulty in merging capital:** Regulatory constraints pose formidable barriers to seamlessly merging commercial and philanthropic capital. This impedes the efficient deployment of resources towards endeavors that require a blend of financial instruments.

## Recommendations

i. **Regulatory amendments:** Introducing targeted amendments to existing regulations can alleviate barriers to blended finance. For instance, amendments to SEBI AIF Regulations and CSR Rules can facilitate direct lending by SIFs and allow multi-year spending plans for corporate social responsibility, respectively.

ii. **Clarity on tax treatment:** The ITA should provide clear guidelines on the tax treatment of income generated from blended finance activities and donations received by social enterprises. Amendments should be made to ensure that grants provided to for-profit entities under the SIF framework do not jeopardize the tax-exempt status of non-profit organizations. Such amendments should aim to create parity between for-profit and non-profit entities engaged in charitable activities while providing clarity on tax treatment for grants and service fees.

iii. **FCRA relaxations:** Relaxations in FCRA regulations can unlock significant potential for blended finance transactions involving foreign capital. However, stringent safeguards must accompany these relaxations to mitigate the risk of misuse of funds.

iv. **Facilitating access to funding:** Measures should be taken to broaden the eligibility criteria for entities seeking foreign contributions under FCRA. This includes relaxing restrictions on for-profit entities and alternative investment funds engaging in socially beneficial activities, thereby expanding the pool of potential recipients of blended finance.

v. **Promotion of innovation:** Regulatory bodies should encourage innovation in CSR practices by providing guidance on innovative CSR approaches and incentivizing companies to explore blended finance models. This can be achieved through recognition programs, tax incentives, and knowledge-sharing platforms.

vi. **Streamlining approval processes:** Simplifying and expediting approval processes under FCRA and other regulatory frameworks is crucial to minimize delays and uncertainties for entities engaged in blended finance. The establishment of dedicated channels or committees for expedited approvals can facilitate timely execution of social impact projects.

vii. **Regulatory sandbox:** Establishing a regulatory sandbox under government guidance can serve as an incubator for innovation in blended finance structures. This platform will facilitate experimentation while ensuring regulatory oversight, thereby fostering confidence among private sector stakeholders.

viii. **Enhanced reporting mechanisms:** Regulatory authorities should develop standardized reporting frameworks to enhance transparency and accountability in blended finance transactions. This will enable stakeholders to track the impact of investments and ensure compliance with regulatory requirements.

ix. **Capacity building:** Government agencies, industry associations, and educational institutions should collaborate to offer capacity-building programs on blended finance structures and regulatory compliance. These initiatives will empower stakeholders with the knowledge and skills necessary to navigate regulatory complexities effectively.

x. **Collaborative platforms:** Establishing collaborative platforms, such as regulatory sandboxes or industry consortia, can facilitate dialogue between regulators, investors, and social enterprises. These platforms will foster innovation, drive regulatory reforms, and promote knowledge exchange in the blended finance ecosystem.

In essence, the regulatory landscape surrounding blended finance in India presents both opportunities and challenges for driving sustainable development. While frameworks like the SEBI AIF Regulations and CSR laws provide a structured framework for mobilizing capital towards social welfare objectives, regulatory complexities and inconsistencies hinder the scalability and efficacy of blended finance initiatives.

Addressing these challenges requires a concerted effort from regulatory authorities, government agencies, private sector stakeholders and civil society organizations. Through strategic regulatory reforms and stakeholder engagement, India can foster an enabling environment for blended finance, driving inclusive and sustainable development for the benefit of all stakeholders.

# About NDA

At Nishith Desai Associates, we have earned the reputation of being Asia's most Innovative Law Firm — and the go-to specialists for companies around the world, looking to conduct businesses in India and for Indian companies considering business expansion abroad. In fact, we have conceptualized and created a state-of-the-art Blue Sky Thinking and Research Campus, Imaginarium Aligunjan, an international institution dedicated to designing a premeditated future with an embedded strategic foresight capability.

We are a research and strategy driven international firm with offices in Mumbai, Palo Alto (Silicon Valley), Bengaluru, Singapore, New Delhi, Munich, and New York. Our team comprises of specialists who provide strategic advice on legal, regulatory, and tax related matters in an integrated manner basis key insights carefully culled from the allied industries.

As an active participant in shaping India's regulatory environment, we at NDA, have the expertise and more importantly — the VISION — to navigate its complexities. Our ongoing endeavors in conducting and facilitating original research in emerging areas of law has helped us develop unparalleled proficiency to anticipate legal obstacles, mitigate potential risks and identify new opportunities for our clients on a global scale. Simply put, for conglomerates looking to conduct business in the subcontinent, NDA takes the uncertainty out of new frontiers.

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The firm has been consistently ranked as one of the Most Innovative Law Firms, across the globe. In fact, NDA has been the proud recipient of the Financial Times–RSG award 4 times in a row, (2014-2017) as the Most Innovative Indian Law Firm.

We are a trust based, non-hierarchical, democratic organization that leverages research and knowledge to deliver extraordinary value to our clients. Datum, our unique employer proposition has been developed into a global case study, aptly titled 'Management by Trust in a Democratic Enterprise,' published by John Wiley & Sons, USA.

## Research@NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

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As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. Imaginarium AliGunjan is a platform for creative thinking; an apolitical ecosystem that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire 'blue sky' thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness — that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear from you about any suggestions you may have on our research publications.
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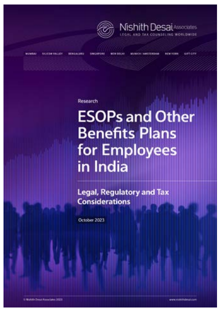


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